NEW APPLICATION

ORIGINAL

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ARIZONA CORPORATION COMMISSION

RECEIVED

Application and Petition for Certificate of Convenience and Necessity to Provide Intrastate Telecommunications Services

2003 JUL 25 P 3: 36

Mail original plus 13 copies of completed application to: For Docket Control Only: (Please Stamp Here)

Arizona Corporation Commission
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JUL 25 2003
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AZ CORP COMMISSION
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Docket Control Center
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007-2927

Please indicate if you have current applications pending in Arizona as an Interexchange reseller, AOS ~~provider,~~ or as the provider of other telecommunication services.

T-04194A-03-0514

Type of Service: ____________________

Docket No.: ____________ Date: ____________ Date Docketed: ____________________

Type of Service: ____________________

Docket No.: ____________ Date: ____________ Date Docketed: ____________________

A. COMPANY AND TELECOMMUNICATION SERVICE INFORMATION

(A-1) Please indicate the type of telecommunications services that you want to provide in Arizona and answer the appropriate numbered items:

- [x] Resold Long Distance Telecommunications Services (Answer Sections A, B).
- [ ] Resold Local Exchange Telecommunications Services (Answer Sections A, B, C).
- [ ] Facilities-Based Long Distance Telecommunications Services (Answer Sections A, B, D).
- [ ] Facilities-Based Local Exchange Telecommunications Services (Answer Sections A, B, C, D, E)
- [ ] Alternative Operator Services Telecommunications Services (Answer Sections A, B)

(A-2) The name, address, telephone number (including area code), facsimile number (including area code), e-mail address, and World Wide Web address (if one is available for consumer access) of the Applicant:

US LEC COMMUNICATIONS INC.
6801 Morrison Boulevard
Charlotte, NC, 28211
(704)-319-1000
(704) 319-3020 (fax)
1-800-978-7532
customerservice@uslec.com
www.uslec.com

438998

(A-3) The d/b/a ("Doing Business As") name if the Applicant is doing business under a name different from that listed in Item (A-2): **None**
(A-4) The name, address, telephone number (including area code), facsimile number (including area code), and E-mail address of the Applicant's Management Contact: **Wanda Montano, Vice-President of Regulatory & Industry Affairs** **6801 Morrison Boulevard** **Charlotte, NC 28211** **(704) 319-1074** **(704) 602-1074 (fax)** **wmontano@uslec.com**
(A-5) The name, address, telephone number (including area code), facsimile number (including area code), and E-mail address of the Applicant's Attorney and/or Consultant: **Joan S. Burke** **Osborn Maledon, P.A.** **2929 North Central Avenue, 21st Floor** **Phoenix, Arizona 85012** **jsburke@omlaw.com** **602-640-9356(voice)** **602-640-6074(fax)** **jsburke@omlaw.com**
(A-6) The name, address, telephone number (including area code), facsimile number (including area code), E-mail address of the Applicant's Complaint Contact Person: **Greg Lunsford, Regulatory Manager** **6801 Morrison Boulevard** **Charlotte, NC 28211** **(704) 319-1946** **(704) 602-1946 (fax)** **glunsford@uslec.com**
(A-7) What type of legal entity is the Applicant? ☐ Sole proprietorship ☐ Partnership: ____ Limited, ____ General, ____ Arizona, ____ Foreign ☐ Limited Liability Company: ____ Arizona, ____ Foreign ☒ Corporation: ____ "S", _X_ "C", ____ Non-profit ☒ Domicile: ____ Arizona, _X_ Foreign (North Carolina) ☐ Other, specify: _____

(A-8) Please include "Attachment A":

Attachment "A" must include the following information:

1. A copy of the Applicant's Certificate of Good Standing as a domestic or foreign corporation, LLC, or other entity in the State of Arizona. **(Attachment A)**
2. A list of the names of all owners, partners, limited liability company managers (or if a member managed LLC, all members), or **corporation officers and directors** (specify). **(Attachment A)**
3. Indicate percentages of ownership of each person listed in A-8.2. **US LEC Communications Inc. is a wholly owned subsidiary of US LEC CORP.**

(A-9) **The US LEC Communications Inc. tariff is included as "Attachment B."**

Your Tariff must include the following information:

1. Proposed Rates and Charges for each service offered: **Tariff pages 42-49.**
2. Tariff Maximum Rate and Prices to be charged: **Tariff pages 42-49**.
3. Terms and Conditions Applicable to provision of Service **Tariff page 11.**
4. Deposits, Advances, and/or Prepayments Applicable to provision of Service (reference by Tariff page number). **None.**
5. The proposed fee that will be charged for returned checks **Tariff page 29.**

(A-10) Indicate the geographic market to be served:

☒ Statewide. (Applicant adopts statewide map of Arizona provided with this application).

☐ Other. Describe and provide a detailed map depicting the area.

(A-11) Indicate if the Applicant or any of its officers, directors, partners, or managers has been or are currently involved in any formal or informal complaint proceedings pending before any state or federal regulatory commission, administrative agency, or law enforcement agency.

Describe in detail any such involvement. Please make sure you provide the following information:

1. States in which the Applicant has been or is involved in proceedings.

   None.
2. Detailed explanations of the Substance of the Complaints.
3. Commission Orders that resolved any and all Complaints.
4. Actions taken by the Applicant to remedy and/or prevent the Complaints from re-occurring.

(A-12) Indicate if the Applicant or any of its officers, directors, partners, or managers has been or are currently involved in any civil or criminal investigation, or had judgments entered in any civil matter, judgments levied by any administrative or regulatory agency, or been convicted of any criminal acts within the last ten (10) years.

None.

Describe in detail any such judgments or convictions. Please make sure you provide the following information:

1. States involved in the judgments and/or convictions.
2. Reasons for the investigation and/or judgment.
3. Copy of the Court order, if applicable.

(A-13) Indicate if the Applicant's customers will be able to access alternative toll service providers or resellers via 1+101XXXX access.

☒ Yes ☐ No

(A-14) Is applicant willing to post a Performance Bond? Please check appropriate box(s).

☒ For Long Distance Resellers, a $10,000 bond will be recommended for those resellers who collect advances, prepayments or deposits.

☐ Yes ☒ No

If "No", continue to question (A-15).

☐ For Local Exchange Resellers, a $25,000 bond will be recommended.

☐ Yes ☐ No

If "No", continue to question (A-15).

☐ For Facilities-Based Providers of Long Distance, a $100,000 bond will be recommended.

☐ Yes ☐ No

If "No", continue to question (A-15).

☐ For Facilities-Based Providers of Local Exchange, a $100,000 bond will be recommended.

☐ Yes ☐ No

If "No", continue to question (A-15).

Note: Amounts are cumulative if the Applicant is applying for more than one type of service.

(A-15) If No to any of the above, provide the following information. Clarify and explain the Applicant's deposit policy (reference by tariff page number). Provide a detailed explanation of why the applicant's superior financial position limits any risk to Arizona consumers.

US LEC will not be collecting advances, prepayments, or deposits from customers. If US LEC were to cease providing service in Arizona, consumers would receive notice and be directed to find a new long distance provider. With respect to intrastate long distance services, Arizona customers have many alternative providers from which to choose. A change in provider can be made quickly, with a single telephone call.

(A-16) Submit copies of affidavits of publication that the Applicant has, as required, published legal notice of the Application in all counties where the applicant is requesting authority to provide service. **US LEC will supplement this application with copies of all necessary affidavits once they are published.**

Note: Prior to issuance of the CC&N, the Applicant must complete and submit an Affidavit of Publication Form as Attachment "C". Refer to the Commission's website for Legal Notice Material (Newspaper Information, Sample Legal Notice and Affidavit of Publication).

(A-17) Indicate if the Applicant is a switchless reseller of the type of telecommunications services that the Applicant will or intends to resell in the State of Arizona:

☒ Yes ☐ No

If "Yes", provide the name of the company or companies whose telecommunications services the Applicant resells.

Global Crossing Telecommunications, Inc.

Sprint Corporation

(A-18) List the States in which the Applicant has had an application approved or denied to offer telecommunications services similar to those that the Applicant will or intends to offer in the State of Arizona:

US LEC Communications Inc. and its affiliates have had telecommunications service applications approved in Alabama, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Indiana, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Montana, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia, West Virginia, Washington DC and Wisconsin

(A-19) List the States in which the Applicant currently offers telecommunications services similar to those that the Applicant will or intends to offer in the State of Arizona.

US LEC Communications Inc. and its affiliates are currently offering telecommunications services in Alabama, California, Connecticut, Delaware, Florida, Georgia, Indiana, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Virginia and Washington, DC

(A-20) List the names and addresses of any alternative providers of the service that are also affiliates of the telecommunications company, as defined in R14-2-801.

US LEC Corp.

US LEC of North Carolina Inc.

US LEC of Alabama Inc.

US LEC of South Carolina Inc.

US LEC of Maryland Inc.

US LEC of Virginia LLC

US LEC of Tennessee Inc.

US LEC of Pennsylvania Inc.

US LEC of Georgia Inc.

US LEC of Florida Inc.

All the above companies are located at 6801 Morrison Boulevard, Charlotte, NC 28211.

B. FINANCIAL INFORMATION

(B-1) Indicate if the Applicant has financial statements for the two (2) most recent years.

☒ Yes ☐ No

If "No," explain why and give the date on which the Applicant began operations.

(B-2) Include "Attachment D". **The 2001 and 2002 10K reports for US LEC are Attachment D to this Application.**

Provide the Applicant's financial information for the two (2) most recent years.

1. A copy of the Applicant's balance sheet.
2. A copy of the Applicant's income statement.
3. A copy of the Applicant's audit report.
4. A copy of the Applicant's retained earnings balance.
5. A copy of all related notes to the financial statements and information.

Note: Make sure "most recent years" includes current calendar year or current year reporting period.

(B-3) Indicate if the Applicant will rely on the financial resources of its Parent Company, if applicable.

US LEC Communications Inc. will rely on the financial resources of its Parent Company.

(B-4) The Applicant must provide the following information.

1. Provide the projected total revenue expected to be generated by the provision of telecommunications services to Arizona customers for the first twelve months following certification, adjusted to reflect the maximum rates for which the Applicant requested approval. Adjusted revenues may be calculated as the number of units sold times the maximum charge per unit.

US LEC Communications Inc., and its affiliates, provide voice, data and Internet services to business customers throughout the southeastern and mid-Atlantic United States. It has no current plans to actively market its services in Arizona and thus has no projected total review for Arizona customers during the first 12 months following certification. US LEC Communications Inc. seeks certification in order to (in the future) offer support services to current facilities-based customers with remote locations in Arizona.

2. Provide the operating expenses expected to be incurred during the first twelve months of providing telecommunications services to Arizona customers following certification.

Please see response to #1 above.

3. Provide the net book value (original cost less accumulated depreciation) of all Arizona jurisdictional assets expected to be used in the provision of telecommunications service to Arizona customers at the end of the first twelve months of operation. Assets are not limited to plant and equipment. Items such as office equipment and office supplies should be included in this list.

Zero.

4. If the projected value of all assets is zero, please specifically state this in your response.
5. If the projected fair value of the assets is different than the projected net book value, also provide the corresponding projected fair value amounts.

C. RESOLD AND/OR FACILITIES-BASED LOCAL EXCHANGE TELECOMMUNICATIONS SERVICES

(C-1) Indicate if the Applicant has a resale agreement in operation,

☐ Yes ☐ No

If "Yes", please reference the resale agreement by Commission Docket Number or Commission Decision Number.

D. FACILITIES-BASED LONG DISTANCE AND/OR FACILITIES BASED LOCAL EXCHANGE TELECOMMUNICATIONS SERVICES

(D-1) Indicate if the Applicant is currently selling facilities-based long distance telecommunications services AND/OR facilities-based local exchange telecommunications services in the State of Arizona. This item applies to an Applicant requesting a geographic expansion of their CC&N:

☐ Yes ☐ No

If "Yes," provide the following information:

1. The date or approximate date that the Applicant began selling facilities-based long distance telecommunications services AND/OR facilities-based local exchange telecommunications services for the State of Arizona.
2. Identify the types of facilities-based long distance telecommunications services AND/OR facilities-based local exchange telecommunications services that the Applicant sells in the State of Arizona.

If "No," indicate the date when the Applicant will begin to sell facilities-based long distance telecommunications AND/OR facilities-based local exchange telecommunications services in the State of Arizona:

(D-2) Check here if you wish to adopt as your petition a statement that the service has already been classified as competitive by Commission Decision:

☐ Decision # 64178 Resold Long Distance

☐ Decision # 64178 Resold LEC

☐ Decision # 64178 Facilities Based Long Distance

☐ Decision # 64178 Facilities Based LEC

E. FACILITIES-BASED LOCAL EXCHANGE TELECOMMUNICATIONS SERVICES

(E-1) Indicate whether the Applicant will abide by the quality of service standards that were approved by the Commission in Commission Decision Number 59241:

☐ Yes ☐ No

(E-2) Indicate whether the Applicant will provide all customers with 911 and E911 service, where available, and will coordinate with incumbent local exchange carriers ("ILECs") and emergency service providers to provide this service:

☐ Yes ☐ No

(E-3) Indicate that the Applicant's switch is "fully equal access capable" (i.e., would provide equal access to facilities-based long distance companies) pursuant to A.A.C. R14-2-1111 (A):

☐ Yes ☐ No

I certify that if the applicant is an Arizona corporation, a current copy of the Articles of Incorporation is on file with the Arizona Corporation Commission and the applicant holds a Certificate of Good Standing from the Commission. If the company is a foreign corporation or partnership, I certify that the company has authority to transact business in Arizona. I certify that all appropriate city, county, and/or State agency approvals have been obtained. Upon signing of this application, I attest that I have read the Commission's rules and regulations relating to the regulations of telecommunications services (A.A.C. Title 14, Chapter 2, Article 11) and that the company will abide by Arizona state law including the Arizona Corporation Commission Rules. I agree that the Commission's rules apply in the event there is a conflict between those rules and the company's tariff, unless otherwise ordered by the Commission. I certify that to the best of my knowledge the information provided in this Application and Petition is true and correct.

Wanda G. Montano
(Signature of Authorized Representative)

July 25, 2003
(Date)

Wanda G. Montano
(Print Name of Authorized Representative)

Vice President Regulatory + Industry Affairs
(Title)

State NC
County Mecklenburg

SUBSCRIBED AND SWORN to before me this 25 day of July, 2003

NOTARY PUBLIC

My Commission Expires June 1, 2004

06/02/03

A

STATE OF ARIZONA

Office of the
CORPORATION COMMISSION

CERTIFICATE OF GOOD STANDING

To all to whom these presents shall come, greeting:

I, James G. Jayne, Interim Executive Secretary of the Arizona Corporation Commission, do hereby certify that

******US LEC COMMUNICATIONS INC.******

a foreign corporation organized under the laws of North Carolina did obtain authority to transact business in the State of Arizona on the 23rd day of February 2002.

I further certify that according to the records of the Arizona Corporation Commission, as of the date set forth hereunder, the said corporation has not had its authority revoked for failure to comply with the provisions of the Arizona Business Corporation Act; that its most recent Annual Report, subject to the provisions of A.R.S. sections 10-122, 10-123, 10-125 & 10-1622, has been delivered to the Arizona Corporation Commission for filing; and that the said corporation has not filed an Application for Withdrawal as of the date of this certificate.

This certificate relates only to the legal authority of the above named entity as of the date issued. This certificate is not to be construed as an endorsement, recommendation, or notice of approval of the entity's condition or business activities and practices.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the official seal of the Arizona Corporation Commission. Done at Phoenix, the Capital, this 14th Day of July, 2003, A. D.

SEAL OF THE ARIZONA CORPORATION COMMISSION
DITAT DEUS
1912

Interim Executive Secretary

By

Attachment A

US LEC COMMUNICATIONS INC. Officers

Aaron D. Cowell, Jr. 6801 Morrison Boulevard Morrocroft III Charlotte, NC 28211	President and Chief Executive Officer
Michael K. Robinson 6801 Morrison Boulevard Morrocroft III Charlotte, NC 28211	Executive Vice President – Finance, Chief Financial Officer and Assistant Secretary
Thomas R. Gooley 6801 Morrison Boulevard Morrocroft III Charlotte, NC 28211	Vice President – Treasury and Treasurer And Assistant Secretary
Amy G. Wotta 6801 Morrison Boulevard Morrocroft III Charlotte, NC 28211	Vice President / Financial Controls
S. Shane Turley 6801 Morrison Boulevard Morrocroft III Charlotte, NC 28211	Secretary

US LEC COMMUNICATIONS INC. Directors

Aaron D. Cowell, Jr.
6801 Morrison Boulevard
Morrocroft III
Charlotte, NC 28211

Richard T. Aab
6801 Morrison Boulevard
Morrocroft III
Charlotte, NC 28211
Put officer list here.

B

REGULATIONS AND SCHEDULE OF INTRASTATE CHARGES

APPLYING TO INTEREXCHANGE

COMMUNICATIONS SERVICES WITHIN

THE STATE OF ARIZONA

This tariff is on file with the Arizona Corporation Commission. In addition, this tariff is available for review at the Company's principle place of business, Monday – Friday, 9:00 a.m. to 5:00 p.m. local time, located at 6801 Morrison Boulevard, Charlotte, NC 28211.

Phone 1-800-978-7532 (toll free)

Issued by: Wanda G. Montano, V.P. Regulatory and Industry Affairs
US LEC Communications Inc.
6801 Morrison Boulevard
Charlotte, North Carolina 28211

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SYMBOLS

The following symbols shall be used in this tariff for the purpose indicated below:

C	To signify changed regulation.
D	To signify discontinued rate or regulation.
I	To signify increased rate.
M	To signify a move in the location of text.
N	To signify new rate or regulation.
R	To signify reduced rate.
S	To signify reissued matter.
T	To signify a change in text but no change in rate or regulation.

TARIFF FORMAT

A. Page Numbering - Page numbers appear in the upper right corner of the page. Pages are numbered sequentially. However, new pages are occasionally added to the tariff. When a new page is added between pages already in effect, a decimal is added. For example, a new page added between pages 14 and 15 would be 14.1.

B. Page Revision Numbers - Revision numbers also appear in the upper right corner of each page. These numbers are used to determine the most current page version on file with the Commission. For example, the 4th revised Page 14 cancels the 3rd revised Page 14. Because of various suspension periods, deferrals, etc. the Commission follows in their tariff approval process, the most current page number on file with the Commission is not always the tariff page in effect.

TARIFF FORMAT (Cont'd)

C. Paragraph Numbering Sequence - There are nine levels of paragraph coding. Each level of coding is subservient to its next higher level:

2.
2.1.
2.1.1.
2.1.1.A.
2.1.1.A.1.
2.1.1.A.1.(a).
2.1.1.A.1.(a).I.
2.1.1.A.1.(a).I.(i).
2.1.1.A.1.(a).I.(i).(1).

APPLICATION OF TARIFF

This tariff sets forth the service offerings, rates, terms and conditions applicable to the furnishing of interexchange services by US LEC Communications Inc., to residential and business customers within the State of Arizona. US LEC Communications Inc. operates as a competitive telecommunications company.

Issued by: Wanda G. Montano, V.P. Regulatory and Industry Affairs
US LEC Communications Inc.
6801 Morrison Boulevard
Charlotte, North Carolina 28211

SECTION 1 - DEFINITIONS

Certain terms used generally throughout this tariff are defined below.

Advance Payment: Part or all of a payment required before the start of service.

Automatic Number Identification (ANI): Allows the automatic transmission of a caller's billing account telephone number to a local exchange company, interexchange carrier or a third party subscriber. The primary purpose of ANI is to allow for billing of toll calls.

Bit: The smallest unit of information in the binary system of notation.

Commission: The Arizona Corporation Commission

Communications Services: The Company's switched intrastate toll telephone services offered for both intraLATA and interLATA use.

Company: US LEC Communications Inc., the issuer of this tariff.

Customer or Subscriber: The person, firm or corporation which orders service and is responsible for the payment of charges and compliance with the Company's regulations.

Dial Pulse (or "DP"): The pulse type employed by rotary dial station sets.

Dual Tone Multi-Frequency (or "DTMF"): The pulse type employed by tone dial station sets.

Duplex Service: Service which provides for simultaneous transmission in both directions.

Federal Communications Commission (or “FCC”): Independent government agency that develops and implements policy concerning interstate and international communications.

Fiber Optic Cable: A thin filament of glass with a protective outer coating through which a light beam carrying communications signals may be transmitted by means of multiple internal reflections to a receiver, which translates the message.

SECTION 1 - DEFINITIONS

In-Only: A service attribute that restricts outward dial access and routes incoming calls to a designated answer point.

Joint User: A person, firm or corporation which is designated by the Customer as a user of services furnished to the Customer by the Company and to whom a portion of the charges for the service will be billed under a joint user arrangement as specified herein.

Kbps: Kilobits per second, denotes thousands of bits per second.

LATA: A Local Access and Transport Area established pursuant to the Modification of Final Judgment entered by the United States District Court for the District of Columbia in Civil Action No. 82-0192; or any other geographic area designated as a LATA in the National Exchange Carrier Association, Inc. Tariff F.C.C. No. 4.

Local Exchange Carrier or ("LEC"): Denotes any individual, partnership, association, joint-stock company, trust or corporation engaged in providing switched communication within an exchange.

Mbps: Megabits, denotes millions of bits per second.

Multi-Frequency or ("MF"): An inter-machine pulse-type used for signaling between telephone switches, or between telephone switches and PBX/key systems.

Recurring Charges: The monthly charges to the Customer for services, facilities and equipment, which continue for the agreed upon duration of the service.

Service Commencement Date: The first day following the date on which the Company notifies the Customer that the requested service or facility is available for use, unless extended by the Customer's refusal to accept service which does not conform to standards set forth in the Service Order or this tariff, in which case the Service Commencement Date is the date of the Customer's acceptance. The Company and Customer may mutually agree on a substitute Service Commencement Date.

SECTION 1 - DEFINITIONS

Service Order: The written request for Network Services executed by the Customer and the Company in the format devised by the Company. The signing of a Service Order by the Customer and acceptance by the Company initiates the respective obligations of the parties as set forth therein and pursuant to this tariff, but the duration of the service is calculated from the Service Commencement Date.

Shared: A facility or equipment system or subsystem that can be used simultaneously by several Customers.

Two Way: A service attribute that includes outward dial capabilities for outbound calls and can also be used to carry inbound calls to a central point for further processing.

User or End User: A Customer, Joint User, or any other person authorized by a Customer to use service provided under this tariff.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company

2.1.1 Scope

The Company undertakes to furnish intrastate communications service for residential and business customers pursuant to the terms of this tariff in connection with one-way and/or two-way information transmission between points within the State of Arizona.

Customers and users may use services and facilities provided under this tariff to obtain access to services offered by other service providers. The Company is responsible under this tariff only for the services and facilities provided hereunder, and it assumes no responsibility for any service provided by any other entity that purchases access to the Company network in order to originate or terminate its own services, or to communicate with its own customers.

2.1.2 Shortage of Equipment or Facilities

A) The Company reserves the right to limit or to allocate the use of existing facilities, or of additional facilities offered by the Company, when necessary because of lack of facilities, or due to some other cause beyond the Company's control.

B) The furnishing of service under this tariff is subject to the availability on a continuing basis of all the necessary facilities and is limited to the capacity of the Company's facilities as well as facilities the Company may obtain from other carriers to furnish service from time to time as required at the sole discretion of the Company.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.3 Terms and Conditions

A) Service is provided on the basis of a minimum period of at least one month, 24-hours per day. For the purpose of computing charges in this tariff, a month is considered to have 30 days.

B) Customers may be required to enter into written service orders which shall contain or reference a specific description of the service ordered, the rates to be charged, the duration of the services, and the terms and conditions in this tariff. Customer will also be required to execute any other documents as may be reasonably requested by the Company.

C) At the expiration of the initial term specified in each Service Order, or in any extension thereof, service shall continue on a month to month basis at the then current rates unless terminated by either party upon 30 days notice. Any termination shall not relieve the Customer of its obligation to pay any charges incurred under the service order and this tariff prior to termination. The rights and obligations which by their nature extend beyond the termination of the term of the service order shall survive such termination. In the event of a termination after the initial service term, advance charges will be billed on a pro-rate basis.

D) Service may be terminated upon written notice to the Customer if:

1) the Customer is using the service in violation of this tariff;
2) or, the Customer is using the service in violation of the law.

E) This tariff shall be interpreted and governed by the laws of the State of Arizona without regard for its choice of laws provision.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.4 Liability of the Company

A) The liability of the Company for damages arising out of the furnishing of its Services, including but not limited to mistakes, omissions, interruptions, delays, or errors, or other defects, representations, or use of these services or arising out of the failure to furnish the service, whether caused by acts or omission, shall be limited to the extension of allowances for interruption as set forth in 2.6. The extension of such allowances for interruption shall be the sole remedy of the Customer and the sole liability of the Company. The Company will not be liable for any direct, indirect, incidental, special, consequential, exemplary or punitive damages to Customer as a result of any Company service, equipment or facilities, or the acts or omissions or negligence of the Company's employees or agents.

B) The Company shall not be liable for any delay or failure of performance or equipment due to causes beyond its control, including but not limited to: acts of God, fire, flood, explosion or other catastrophes; any law, order, regulation, direction, action, or request of the United States Government, or of any other government, including state and local governments having or claiming jurisdiction over the Company, or of any department, agency, commission, bureau, corporation, or other instrumentality of any one or more of these federal, state, or local governments, or of any civil or military authority; national emergencies; insurrections; riots; wars; unavailability of rights-of-way or materials; or strikes, work stoppages, or other labor difficulties.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.4 Liability of the Company (Cont'd)

C) The Company shall not be liable for any act or omission of any entity furnishing to the Company or to the Company's Customers facilities or equipment used for or with the services the Company offers.

D) The Company shall not be liable for any damages or losses due to the fault or negligence of the Customer or due to the failure or malfunction of Customer-provided equipment or facilities.

E) The Company does not guarantee nor make any warranty with respect to installations it provides for use in an explosive atmosphere. The Customer indemnifies and holds the Company harmless from any and all loss, claims, demands, suits, or other action, or any liability whatsoever, whether suffered, made, instituted, or asserted by any other party or person(s), and for any loss, damage, or destruction of any property, whether owned by the Customer or others, caused or claimed to have been caused directly or indirectly by the installation, operation, failure to operate, maintenance, removal presence, condition, location, or use of any installation so provided. The Company reserves the right to require each Customer to sign an agreement acknowledging acceptance of the provisions of this section 2.1.4(E) as a condition precedent to such installations.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.4 Liability of the Company (Cont'd)

F) The Company is not liable for any defacement of or damage to Customer premises resulting from the furnishing of services or equipment on such premises or the installation or removal thereof, unless such defacement or damage is caused by negligence or willful misconduct of the Company's agents or employees.

G) The Company shall be indemnified, defended and held harmless by the Customer against any claim, loss or damage arising from Customer's use of services, involving claims for libel, slander, invasion of privacy, or infringement of copyright arising from the Customer's own communications.

H) THE COMPANY MAKES NO WARRANTIES OR REPRESENTATIONS, EXPRESS OR IMPLIED EITHER IN FACT OR BY OPERATION OF LAW, STATUTORY OR OTHERWISE, INCLUDING WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR USE, EXCEPT THOSE EXPRESSLY SET FORTH HEREIN.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.5 Notification of Service-Affecting Activities

The Company will provide the Customer reasonable notification of service-affecting activities that may occur in normal operation of its business. Such activities may include, but are not limited to, equipment or facilities additions, removals or rearrangements and routine preventative maintenance. Generally, such activities are not specific to an individual Customer but affect many Customers' services. No specific advance notification period is applicable to all service activities. The Company will work cooperatively with the Customer to determine the reasonable notification requirements. With some emergency or unplanned service-affecting conditions, such as an outage resulting from cable damage, notification to the Customer may not be possible.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.6 Provision of Equipment and Facilities

A) The Company shall use reasonable efforts to make available services to a Customer on or before a particular date, subject to the provisions of and compliance by the Customer with, the regulations contained in this tariff. The Company does not guarantee availability by any such date and shall not be liable for any delays in commencing service to any Customer.

B) The Company shall use reasonable efforts to maintain only the facilities and equipment that it furnishes to the Customer. The Customer may not, nor may the Customer permit others to, rearrange, disconnect, remove, attempt to repair, or otherwise interfere with any of the facilities or equipment installed by the Company, except upon the written consent of the Company.

C) The Company may substitute, change or rearrange any equipment or facility at any time and from time to time, but shall not thereby alter the technical parameters of the service provided the Customer.

D) Equipment the Company provides or installs at the Customer Premises for use in connection with the services the Company offers shall not be used for any purpose other than that for which the Company provided it.

E) The Customer shall be responsible for the payment of service charges as set forth herein for visits by the Company's agents or employees to the Premises of the Customer when the service difficulty or trouble report results from the use of equipment or facilities provided by any party other than the Company, including but not limited to the Customer.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.6 Provision of Equipment and Facilities (Cont'd)

F) The Company shall not be responsible for the installation, operation, or maintenance of any Customer provided communications equipment. Where such equipment is connected to the facilities furnished pursuant to this tariff, the responsibility of the Company shall be limited to the furnishing of facilities offered under this tariff and to the maintenance and operation of such facilities. Subject to this responsibility, the Company shall not be responsible for:

1) the transmission of signals by Customer provided equipment or for the quality of, or defects in, such transmission; or

2) the reception of signals by Customer-provided equipment.

2.1.7 Non-Routine Installation

At the Customer's request, installation and/or maintenance may be performed outside the Company's regular business hours or in hazardous locations. In such cases, charges based on cost of the actual labor, material, or other costs incurred by or charged to the Company will apply. If installation is started during regular business hours but, at the Customer's request, extends beyond regular business hours into time periods including, but not limited to, weekends, holidays, and/or night hours, additional charges may apply.

SECTION 2 - REGULATIONS

2.1 Undertaking of the Company (Cont'd)

2.1.8 Ownership of Facilities

Title to all facilities, other than inside wiring on the Customer's side of the demarcation point, provided in accordance with this tariff remains in the Company, its agents or contractors.

SECTION 2 - REGULATIONS

2.2 Prohibited Uses

A) The services the Company offers shall not be used for any unlawful purpose or for any use as to which the Customer has not obtained all required governmental approvals, authorizations, licenses, consents and permits.

B) The Company may require applicants for service who intend to use the Company's offerings for resale and/or for shared use to file a letter with the Company confirming that their use of the Company's offerings complies with relevant laws and Arizona Corporation Commission regulations, policies, orders, and decisions.

C) The Company may require a Customer to immediately shut down its transmission of signals if said transmission is causing interference to others.

D) A customer, joint user, or authorized user may not assign, or transfer in any manner, the service or any rights associated with the service without the written consent of the Company. The Company will permit a Customer to transfer its existing service to another entity if the existing Customer has paid all charges owed to the Company for regulated communications services. Such a transfer will be treated as a disconnection of existing service and installation of new service, and non-recurring installation charges as stated in this tariff will apply.

SECTION 2 - REGULATIONS

2.3 Obligations of the Customer

2.3.1 General

The Customer shall be responsible for:

A) the payment of all applicable charges pursuant to this tariff;

B) damage to or loss of the Company's facilities or equipment caused by the acts or omissions of the Customer; or the noncompliance by the Customer, with these regulations; or by fire or theft or other casualty on the Customer Premises, unless caused by the negligence or willful misconduct of the employees or agents of the Company;

C) providing at no charge, as specified from time to time by the Company, any needed personnel, equipment space and power to operate Company facilities and equipment installed on the premises of the Customer, and the level of heating and air conditioning necessary to maintain the proper operating environment on such premises;

D) obtaining, maintaining, and otherwise having full responsibility for all rights-of-way and conduit necessary for installation of fiber optic cable and associated equipment used to provide Communications Services to the Customer from the cable building entrance or property line to the location of the equipment space described in 2.3.1(C). Any and all costs associated with the obtaining and maintaining the rights-of-way described herein, including the costs of altering the structure to permit installation of the Company-provided facilities, shall be borne entirely by, or may be charged by the Company to, the Customer. The Company may require the Customer to demonstrate its compliance with this section prior to accepting an order for service;

SECTION 2 - REGULATIONS

2.3 Obligations of the Customer (Cont'd)

2.3.1 General (Cont'd)

E) providing a safe place to work and complying with all laws and regulations regarding the working conditions on the premises at which Company employees and agents shall be installing or maintaining the Company's facilities and equipment. The Customer may be required to install and maintain Company facilities and equipment within a hazardous area if, in the Company's opinion, injury or damage to the Company employees or property might result from installation or maintenance by the Company. The Customer shall be responsible for identifying, monitoring, removing and disposing of any hazardous material (e.g. friable asbestos) prior to any construction or installation work;

F) complying with all laws and regulations applicable to, and obtaining all consents, approvals, licenses and permits as may be required with respect to, the location of Company facilities and equipment in any Customer premises or the rights-of-way for which Customer is responsible under Section 2.3.1(D); and granting or obtaining permission for Company agents or employees to enter the premises of the Customer at any reasonable time for the purpose of installing, inspecting, maintaining, repairing, or upon termination of service as stated herein, removing the facilities or equipment of the Company;

G) not creating or allowing to be placed any liens or other encumbrances on the Company's equipment or facilities; and

H) making Company facilities and equipment available periodically for maintenance purposes at a time agreeable to both the Company and the Customer. No allowance will be made for the period during which service is interrupted for such purposes.

SECTION 2 - REGULATIONS

2.3 Obligations of the Customer (Cont'd)

2.3.2 Claims

With respect to any service or facility provided by the Company, Customer shall indemnify, defend and hold harmless the Company from and against all claims, actions, damages, liabilities, costs and expenses, including reasonable attorneys' fees for:

A) any loss, destruction or damage to property of the Company or any third party, or the death or injury to persons, including, but not limited to, employees or invitees of either party, to the extent caused by or resulting from the negligent or intentional act or omission of the Customer, its employees, agents, representatives or invitees; or

B) any claim, loss, damage, expense or liability for infringement of any copyright, patent, trade secret, or any proprietary or intellectual property right of any third party, arising from any act or omission by the Customer, including, without limitation, use of the Company's services and facilities in a manner not contemplated by the agreement between the Customer and the Company.

SECTION 2 - REGULATIONS

2.4 Customer Equipment and Channels

2.4.1 General

A User may transmit or receive information or signals via the facilities of the Company. The Company's services are designed primarily for the transmission of voice-grade telephonic signals, except as otherwise stated in this tariff. A User may transmit any form of signal that is compatible with the Company's equipment, but the Company does not guarantee that its services will be suitable for purposes other than voice-grade telephonic communication except as specifically stated in this tariff.

2.4.2 Station Equipment

A) Terminal equipment on the User's Premises and the electric power consumed by such equipment shall be provided by and maintained at the expense of the User. The User is responsible for the provision of wiring or cable to connect its terminal equipment to the Company Point of Connection.

B) The Customer is responsible for ensuring that Customer-provided equipment connected to Company equipment and facilities is compatible with such equipment and facilities. The magnitude and character of the voltages and currents impressed on Company-provided equipment and wiring by the connection, operation, or maintenance of such equipment and wiring shall be such as not to cause damage to the Company-provided equipment and wiring or injury to the Company's employees or to other persons. Any additional protective equipment required to prevent such damage or injury shall be provided by the Company at the Customer's expense.

SECTION 2 - REGULATIONS

2.4 Customer Equipment and Channels (Cont'd)

2.4.3 Interconnection of Facilities

A) Any special interface equipment necessary to achieve compatibility between the facilities and equipment of the Company used for furnishing Communications Services and the channels, facilities, or equipment of others shall be provided at the Customer's expense.

B) Communications Services may be connected to the services or facilities of other communications carriers only when authorized by, and in accordance with, the terms and conditions of the tariffs of the other communications carriers which are applicable to such connections.

C) Facilities furnished under this tariff may be connected to customer provided terminal equipment in accordance with the provisions of this tariff. All such terminal equipment shall be registered by the Federal Communications Commission pursuant to Part 68 of Title 47, Code of Federal Regulations; and all User-provided wiring shall be installed and maintained in compliance with those regulations.

D) Users may interconnect communications facilities that are used in whole or in part for interstate communications to services provided under this tariff only to the extent that the user is an "end user" as defined in Section 69.2(m), Title 47, Code of Federal Regulations (1992 edition).

SECTION 2 - REGULATIONS

2.4 Customer Equipment and Channels (Cont'd)

2.4.4 Inspections

A) Upon suitable notification to the Customer, and at a reasonable time, the Company may make such tests and inspections as may be necessary to determine that the Customer is complying with the requirements set forth in Section 2.4.2(B) for the installation, operation, and maintenance of Customer-provided facilities, equipment, and wiring in the connection of Customer-provided facilities and equipment to Company-owned facilities and equipment.

B) If the protective requirements for Customer-provided equipment are not being complied with, the Company may take such action as it deems necessary, to protect its facilities, equipment, and personnel. The Company will notify the Customer promptly if there is any need for further corrective action. Within ten days of receiving this notice, the Customer must take this corrective action and notify the Company of the action taken. If the Customer fails to do this, the Company may take whatever additional action is deemed necessary, including the suspension of service, to protect its facilities, equipment and personnel from harm.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements

2.5.1 Payment for Service

The Customer is responsible for payment of all charges for services and facilities furnished by the Company to the Customer, as well as all charges for services and facilities furnished by the Company to all persons using the Customer's codes, premises, facilities, or equipment, with or without the knowledge or consent of the Customer. The security of the Customer's authorization codes, premises, switched access connections, and direct connect facilities is the sole responsibility of the Customer. All calls placed using such direct connect facilities, authorization codes, premises, or switched access connections will be billed to, and must be paid by, the Customer.

A) Taxes

All charges and fees subject to Arizona Corporation Commission jurisdiction, except taxes and franchise fees, will be submitted to the ACC for prior approval.

The Customer is responsible for payment of any sales, use, gross receipts, excise, access or other local, state and federal taxes, charges or surcharges (however, designated) (excluding taxes on Company's net income) imposed on or based upon the provision, sale or use of Network Services.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.2 Billing and Collection of Charges

A) Non-recurring charges are due and payable from the customer upon receipt of the invoice.

B) The Company shall present invoices for Recurring Charges monthly to the Customer, in advance of the month in which service is provided, and Recurring Charges shall be due upon receipt of the invoice. When billing is based on customer usage, charges will be billed monthly for the preceding billing periods.
Billing Format:
Page 1:Summarizes previous balance, adjustments, payments/credits, new charges and balance due. Includes account specific bill message. Contains remittance stub for payment.
Page 2: Answers to frequently asked bill questions. Lists US LEC entities.
Page 3: Federal Taxes, State/Other Taxes, Payments/Credits, Discounts, Account Level Charges, Usage Summary by Type of Call, Number of Calls, Number of Minutes and Charges.
Page 4+: Service Instance (phone number, calling card number, etc.), Non-Recurring Charges, Monthly Recurring Charges, Usage Detail, Total for Service Instance.

C) When service does not begin on the first day of the month, or end on the last day of the month, the charge for the fraction of the month in which service was furnished will be calculated on a pro rate basis. For this purpose, every month is considered to have 30 days.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.2 Billing and Collection of Charges (Cont'd)

D) Billing of the Customer by the Company will begin on the Service Commencement Date, which is the first day following the date on which the Company notifies the Customer that the service or facility is available for use, except that the Service Commencement Date may be postponed by mutual agreement of the parties, or if the service or facility does not conform to standards set forth in this tariff or the Service Order. Billing accrues through and includes the day that the service, circuit, arrangement or component is discontinued.

E) A late payment penalty will be due to the Company upon any current unpaid amount commencing 28 days after the date of the invoice. The late payment penalty shall be the portion of the current payment minus any charges billed as taxes for any local government not received by the 28th day after the date of the invoice multiplied by a late factor of 1.5%.

1. The date on which the bill is delivered to the U.S. Mail, or delivered to the customer's premises, along with the date by which the payment must be received, will be printed on the Customer's bill

2. The late payment charge shall not be applied to any amount billed as taxes which utilities are required to collect on behalf of local government.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.2 Billing and Collection of Charges (Cont'd)

F) The Customer will be assessed a charge of twenty dollars ($20.00) for each check submitted by the Customer to the Company which a financial institution refused to honor.

G) Customers have up to 45 days (commencing 5 days after remittance of the bill) to initiate a dispute over regulated charges. If a Customer does not give the Company notice of a billing or rate dispute within the above mentioned dispute period, the invoice and the charges levied shall be deemed to be reasonable, correct and binding on the Customer. Late payment penalties on unpaid charges disputed by and resolved in favor of the Customer shall be credited.

H) If service is disconnected by the Company in accordance with section 2.5.3 following and later restored, restoration of service will be subject to all applicable installation charges.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.3 Discontinuance of Service

A) Upon nonpayment of any regulated amounts owing to the Company, the Company may, by giving 10 business days prior written notice to the Customer, discontinue or suspend service without incurring any liability. In cases of bankruptcy, receivership, abandonment of service, or abnormal toll usage not covered adequately by security deposit, Company may give Customer less than 5 days notice in order to protect the Company's revenues. Service may not be denied on the last business day of any week or the last business day prior to the holidays as specified elsewhere in this tariff unless the Customer's failure to keep prior payment promises, bankruptcy, receivership, abandonment of service, or abnormal toll usage is involved.

B) Upon violation of any of the other material terms or conditions for furnishing service the Company may, by giving 10 days' prior notice in writing to the Customer, discontinue or suspend service without incurring any liability if such violation continues during that period.

C) Upon condemnation of any material portion of the facilities used by the Company to provide service to a Customer or if a casualty renders all or any material portion of such facilities inoperable beyond feasible repair, the Company, by notice to the Customer, may discontinue or suspend service without incurring any liability.

D) Upon any governmental prohibition or required alteration of the services to be provided or any violation of an applicable law or regulation, the Company may immediately discontinue service without incurring any liability.

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.3 Discontinuance of Service (Cont'd)

E) In the event of fraudulent use of the Company's network, the Company will discontinue service without notice and/or seek legal recourse to recover all costs involved in enforcement of this provision.

F) Upon the Company's discontinuance of service to the Customer under Section 2.5.3(A) or 2.5.3(B), the Company, in addition to all other remedies that may be available to the Company at law or in equity or under any other provision of this tariff, may declare all future monthly and other charges which would have been payable by the Customer during the remainder of the term for which such services would have otherwise been provided to the Customer to be immediately due and payable (discounted to present value at six percent). For good cause shown, the Commission may exempt a Customer from the penalties provided in this sub-section.

2.5.4 Cancellation of Application for Service

A) Where, prior to cancellation by the Customer, the Company incurs any expenses in installing the service or in preparing to install the service that it otherwise would not have incurred, a charge equal to the costs the Company incurred, less net salvage, shall apply, but in no case shall this charge exceed the sum of the charge for the minimum period of services ordered, including installation charges, and all charges others levy against the Company that would have been chargeable to the Customer had service begun (all discounted to present value at six percent).

SECTION 2 - REGULATIONS

2.5 Payment Arrangements (Cont'd)

2.5.4 Cancellation of Application for Service (cont'd)

B) Where the Company incurs any expense in connection with special construction, or where special arrangements of facilities or equipment have begun, before the Company receives a cancellation notice, a charge equal to the costs incurred, less net salvage, applies. In such cases, the charge will be based on such elements as the cost of the equipment, facilities, and material, the cost of installation, engineering, labor, and supervision, general and administrative expense, other disbursements, depreciation, maintenance, taxes, provision for return on investment, and any other costs associated with the special construction or arrangements.

C) The special charges described in 2.5.4(A) through 2.5.4(B) will be calculated and applied on a case-by-case basis.

2.5.5 Changes in Service Requested

If the Customer makes or requests material changes in circuit engineering, equipment specifications, service parameters, premises locations, or otherwise materially modifies any provision of the application for service, the Customer's installation fee shall be adjusted accordingly.

2.5.6 Settlement Agreements

If a residential customer is unable to pay a charge when due, the Company and the residential customer will enter into an initial settlement agreement under which the charge may be paid as mutually agreed to by both parties.

SECTION 2 - REGULATIONS

2.6 Allowances for Interruptions in Service

Interruptions in service, which are not due to the negligence of, or noncompliance with the provisions of this tariff by, the Customer or the operation or malfunction of the facilities, power or equipment provided by the Customer, will be credited to the Customer as set forth in 2.6.1 for the part of the service that the interruption affects.

2.6.1 Credit for Interruptions

A) When service is interrupted for a period of at least 24 hours after notice by the Customer to the Company, an allowance equal to 1/30 of fixed billing cycle charges for services and facilities furnished by the Company rendered useless or substantially impaired shall apply to each 24 hours during which the interruption continues after notice by the customer to the Company. Credit in any billing period shall not exceed the total non-usage charges for that period for the services and facilities furnished by the Company rendered useless or substantially impaired.

(i) The word "interruption" shall mean the inability to complete calls due to equipment malfunctions or human errors. "Interruption" does not include, and no allowance shall be given for, service difficulties such as slow dial tone, circuits, busy or other network and/or switching capacity shortages. Nor shall "interruption" include the failure of any service or facilities provided by a common carrier or other entity other than the Company. Nor shall the interruption allowance apply where service is interrupted by the negligence or willful act of the customer, or where the Company, pursuant to the terms of this tariff, terminates service because of non-payment of bills or deposits due to the Company, unlawful or improper use of the Company's facilities or service, or any other reason covered by this tariff or by applicable law.

(ii) No allowance shall apply to any non-recurring or usage charges.

SECTION 2 - REGULATIONS

2.6 Allowances for Interruptions in Service (Cont'd)

2.6.2 Limitations on Allowances

No credit allowance will be made for:

A) interruptions due to the negligence of, or noncompliance with the provisions of this tariff by, the Customer, authorized user, joint user, or other common carrier providing service connected to the service of the Company;

B) interruptions due to the negligence of any person other than the Company, including but not limited to the Customer or other common carriers connected to the Company's facilities;

C) interruptions due to the failure or malfunction of non-Company equipment;

D) interruptions of service during any period in which the Company is not given full and free access to its facilities and equipment for the purpose of investigating and correcting interruptions;

E) interruptions of service during a period in which the Customer continues to use the service on an impaired basis;

F) interruptions of service during any period when the Customer has released service to the Company for maintenance purposes or for implementation of a Customer order for a change in service arrangements; and

G) interruption of service due to circumstances or causes beyond the control of Company.

SECTION 2 - REGULATIONS

2.6 Allowances for Interruptions in Service (Cont'd)

2.6.3 Cancellation For Service Interruption

Cancellation or termination for service interruption is permitted only if any circuit experiences a single continuous outage of 8 hours or more or cumulative service credits equaling 16 hours in a continuous 12-month period. The right to cancel service under this provision applies only to the single circuit which has been subject to the outage or cumulative service credits.

2.7 Use of Customer's Service by Others

2.7.1 Resale and Sharing

Any service provided under this tariff may be resold to or shared with other persons at the option of Customer, subject to compliance with any applicable laws or Arizona Corporation Commission governing such resale or sharing. Customer remains solely responsible for all use of services ordered by it or billed to its telephone number(s) pursuant to this tariff, for determining who is authorized to use its services, and for notifying the Company of any unauthorized use.

2.7.2 Joint Use Arrangements

Joint use arrangements will be permitted for all services provided under this tariff. From each joint use arrangement, one member will be designated as the Customer responsible for the manner in which the joint use of the service will be allocated. The Company will accept orders to start, rearrange, relocate, or discontinue service only from the Customer. Without affecting the Customer's ultimate responsibility for payment of all charges for the service, each joint user shall be responsible for the payment of the charges billed to it.

SECTION 2 - REGULATIONS

2.8 Cancellation of Service

If a Customer cancels a Service Order or terminates services before the completion of the term for any reason whatsoever other than a service interruption (as defined in 2.6.1 above), the Customer agrees to pay to the Company termination liability charges, which are defined below. These charges shall become due and owing as of the effective date of the cancellation or termination and be payable within the period, set forth in 2.5.2.

The Customer's termination liability for cancellation of service shall be equal to:

A) all unpaid Non-Recurring charges reasonably expended by the Company to establish service to the Customer, plus;

B) any disconnection, early cancellation or termination charges reasonably incurred and paid to third parties by the Company on behalf of the Customer, plus;

C) all Recurring Charges specified in the applicable Service Order Tariff for the balance of the then current term.

2.9 Transfers and Assignments

Neither the Company nor the Customer may assign or transfer its rights or duties in connection with the services and facilities provided by the Company without the written consent of the other party, except that the Company may assign its rights and duties (a) to any subsidiary, parent company or affiliate of the Company, (b) pursuant to any sale or transfer of substantially all the assets of the Company; or (c) pursuant to any financing, merger or reorganization of the Company.

SECTION 2 - REGULATIONS

2.10 Notices and Communications

A) The Customer shall designate on the Service Order an address to which the Company shall mail or deliver all notices and other communications, except that Customer may also designate a separate address to which the Company's bills for service shall be mailed.

B) The Company shall designate on the Service Order an address to which the Customer shall mail or deliver all notices and other communications, except that Company may designate a separate address on each bill for service to which the Customer shall mail payment on that bill.

C) All notices or other communications required to be given pursuant to this tariff are requested to be in writing. At the Company's request, notices or other communications given pursuant to this tariff by the Customer to the Company in a telephone call, may be required to be confirmed in writing. Notices and other communications of either party, and all bills mailed by the Company, shall be presumed to have been delivered to the other party on the third business day following placement of the notice, communication or bill with the U.S. Mail or a private delivery service, prepaid and properly addressed, or when actually received or refused by the addressee, whichever occurs first.

D) The Company or the Customer shall advise the other party of any changes to the addresses designated for notices, other communications or billing, by following the procedures for giving notice set forth herein.

2.11 800 Number Porting

US LEC will participate in porting toll-free numbers only if the customer account balance is zero and all undisputed charges incurred as a result of the toll-free number have been paid.

SECTION 3 - APPLICATION OF RATES

3.1 Introduction

The regulations set forth in this section govern the application of rates for services contained in other sections of this tariff.

3.2 Charges Based on Duration of Use

Where charges for a service are specified based on the duration of use, such as the duration of a telephone call, the following rules apply:

A) Calls are measured in durational increments identified for each service. All calls which are fractions of a measurement increment are rounded-up to the next whole unit.

B) Timing on completed calls begins when the call is answered by the called party. Answering is determined by hardware answer supervision in all cases where this signaling is provided by the terminating local carrier and any intermediate carrier(s). Timing for operator service person-to-person calls start with completion of the connection to the person called or an acceptable substitute, or to the PBX station called.

C) Timing terminates on all calls when the calling party hangs up or the Company's network receives an off-hook signal from the terminating carrier.

D) Calls originating in one time period and terminating in another will be billed in proportion to the rates in effect during different segments of the call.

E) All times refer to local time.

SECTION 3 - APPLICATION OF RATES

3.3 Rates Based Upon Distance

Where charges for a service are specified based upon distance, the following rules:

A) Distance between two points is measured as airline distance between the rate centers of the originating and terminating telephone lines. The rate center is a set of vertical and horizontal (V&H) geographic coordinates, as referenced in the Local Exchange Routing Guide issued by Telcordia, associated with each NPA-NXX combination (where NPA is the area code and NXX is the first three digits of a seven-digit telephone number). Where there is no telephone number associated with an access line on the Company's network (such as a dedicated 800 or WATS access line), the Company will apply the rate center of the Customer's main billing telephone number. The Customer may obtain V&H coordinates from the Company or Telcordia for use in the formulas in determining proper rate treatment for distance-sensitive service rates under this tariff.

SECTION 3 - APPLICATION OF RATES

3.4 Time Periods Defined

Unless otherwise indicated herein:

3.4.1 All rate plans:

a. Day: 8:00 a.m. - 5:00 p.m. - Mon-Fri

b. Evening: 5:00 - 11:00 p.m. - Sun-Fri

c. Night/Weekend: 11:00 p.m. - 8:00 a.m. - All days
8:00 a.m. - 11:00 p.m. - Saturday
8:00 a.m. - 5:00 p.m. - Sunday

d. Holiday: For the following Holidays, the Evening Time Period rates are used, unless a lower rate would normally apply:

Christmas Day**	New Year's Day**
Martin Luther King Day*	Presidents Day*
Memorial Day*	Columbus Day*
Veterans Day**	Thanksgiving Day
Independence Day**	Labor Day

* Applies to Federally observed day only.

** When this Holiday falls on a Sunday, the Holiday calling rate applies to calls placed on the following Monday. When this Holiday falls on a Saturday, the Holiday calling rate applies to calls placed on the preceding Friday.

SECTION 4 - SERVICE AREAS

4.1 Service Areas

4.1 Service Area: The Company includes all the exchanges in Arizona as the potential areas where service is planned, where facilities are available and pending appropriate interconnection agreements.

Issued by: Wanda G. Montano, V.P. Regulatory and Industry Affairs
US LEC Communications Inc.
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SECTION 5 - MESSAGE TELECOMMUNICATIONS SERVICE

5.1 Description

Message Telecommunications Services ("MTS") consist of the furnishing of outbound message telephone service between telephone stations located within the state.

5.2 Rates

a. PROGRAM NAME: Advantage Plus Long Distance Service

BILLING: 30 second minimum/6 second increments
Per minute rates will be prorated.

US LEC Advantage Plus Long Distance Service offers smaller single and multi-line business customers the ability to select US LEC as their Presubscribed Interexchange Carrier for the completion of Intrastate calls. Advantage Plus Long Distance can be used in conjunction with other US LEC toll products, or as a stand-alone offering. Advantage Plus Long Distance is available throughout the entire US LEC service area. However, Advantage Plus will not be available with payphone, cellular or mobile telephone service.

Calls to All Areas	$0.20 per minute

A Monthly Recurring Charge (MRC) is required for any and all locations as follows.

	Per Line
Multi-line Business	$10.00
Centrex Lines	$5.00

SECTION 5 - MESSAGE TELECOMMUNICATIONS SERVICE

Reserved for future use

SECTION 6 – TOLL FREE SERVICE

6.1 Description

Toll Free Service is an inbound-only service in which callers located within the State may place toll-free calls to a telephone in the 800/888/877 area codes assigned to the Customer.

6.2 Rates

a. PROGRAM NAME: Advantage Plus Toll Free Service

BILLING: 30 second minimum/6 second increments

Advantage Plus Toll Free Service is an inbound only service in which callers located within the State may place toll-free calls to a subscriber's telephone number in the toll free area codes assigned to the Customer.

Calls From All Intrastate Areas	$0.20 per minute

Advantage Plus Toll Free Service subscribers will also be subject to a monthly recurring charge for each location subscribed and for each number utilized.

Monthly Recurring per Location	$30.00
Monthly Recurring per Toll Free number	$10.00

SECTION 6 – TOLL FREE SERVICE

Reserved for future use

SECTION 7 - OTHER SERVICE ARRANGEMENTS

Reserved for future use

SECTION 8 - MISCELLANEOUS SERVICES

8.1 Service Implementation

8.1.1 Description

Absent a promotional offering, service implementation charges will apply to new service orders or to orders to change existing service.

8.1.1 Rates

	Non-Recurring
Per Service Order	$50.00

8.2 Restoration of Service

8.2.1 Description

A restoral charge applies to the re-establishment of service and facilities suspended because of nonpayment of bills and is payable at the time that the re-establishment of the service and facilities suspended is arranged for.

8.2.2 Rates

	Non-Recurring
Per Occasion	$50.00

SECTION 8 - MISCELLANEOUS SERVICES

8.3 Payphone Surcharge

8.3.1 Description

US LEC charges a surcharge for 1-8XX and dial-around (101XXXX) calls originating from any payphone used to access the US LEC network where those charges are not otherwise collected at the payphone or by the payphone service provider. The charge is in addition to standard tariffed usage charges and surcharges.

8.3.2 Rates

Per call	\$0.40

8.4 US LEC Calling Card (Post Paid)

8.4.1 Description

Post Paid Calling Cards provide Customers the ability to complete telephone calls from any touch tone phone while directing billing for such calls to their US LEC account. The US LEC Calling Card is a proprietary, 800 number based, calling card product. A distinctive 800/888/877 number, unique to US LEC, is provided upon a unique physical card. Usage will be billed by US LEC to the Customer's US LEC account, broken out by individual user card number.

8.4.2 Rates

Per minute	\$0.30

SECTION 8 - MISCELLANEOUS SERVICES

8.5 Directory Assistance

A Customer may obtain Directory Assistance in determining telephone numbers within the State of Arizona by calling the Directory Assistance operator. Directory Assistance charges apply for all requests for which the Company's facilities are used. Each number requested is charged as shown below. Requests for information other than telephone numbers will be charged the same rate as shown for the applicable request for telephone numbers.

Rate Per Call	$1.50

A credit will be given for calls to Directory Assistance when:

-the Customer experiences poor transmission or is cut-off during the call,
-the Customer is given an incorrect telephone number, or
-the Customer inadvertently misdials an incorrect Directory Assistance NPA.

To receive a credit, the problem experienced must be reported either to the Company operator or Business Office.

SECTION 9 - SPECIAL ARRANGEMENTS

9.1 Temporary Promotional Programs

The Company may make promotional offerings of its tariffed services, which may include reducing or waiving applicable charges for the promoted service. No individual promotional offering will exceed six months in duration, and any promotional offering will be extended on a non-discriminatory basis to any customer similarly classified who requests the specific offer. The Company will submit its Promotions by letter to the Commission Staff outlining the promotion, listing the tariffed item being promoted, and the promotion's start and end dates in lieu of filing language in the tariff.

Issued by: Wanda G. Montano, V.P. Regulatory and Industry Affairs
US LEC Communications Inc.
6801 Morrison Boulevard
Charlotte, North Carolina 28211

C

Attachment C

This Application will be supplemented with the affidavit of publication as soon as it is available.

D

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K
ANNUAL REPORT
PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
FOR THE YEAR ENDED DECEMBER 31, 2001

Commission File Number: 0-24061

US LEC CORP.
(Exact name of registrant as specified in its charter)

DELAWARE	**56-2065535**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

Morrocroft III, 6801 Morrison Boulevard
CHARLOTTE, NORTH CAROLINA 28211
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (704) 319-1000

Securities registered pursuant to Section 12(b) of Act: None.

Securities registered pursuant to Section 12(g) of Act: **Class A Common Stock, par value $.01 per share.**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

The aggregate market value of voting stock of the registrant held by non-affiliates of the registrant was $46,159,955 as of March 21, 2002 based on the closing sales price on The Nasdaq National Market as of that date. For purposes of this calculation only, affiliates are deemed to be directors and executive officers of the registrant.

As of March 21, 2002 there were 26,388,672 shares of Class A Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement ("the Proxy Statement") for its Annual Meeting of Stockholders to be held on May 7, 2002 are incorporated by reference into Part III of this report.

US LEC CORP.
2001 ANNUAL REPORT ON FORM 10-K
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PART I

ITEM 1. BUSINESS

The Company

US LEC Corp. ("US LEC" or the "Company"), is a Charlotte, NC-based telecommunications carrier providing voice, data and Internet services to over 6,800 mid-to-large-sized business customers throughout the southeastern and mid-Atlantic United States. As of December 31, 2001, US LEC's network consisted of 26 Lucent 5ESS® AnyMedia™ digital switches, 25 Lucent CBX500 Asynchronous Transfer Mode ("ATM") data switches, 4 Juniper Networks® M20™ Internet Gateway routers and an Alcatel MegaHub® 600ES tandem switch. The US LEC service area includes Alabama, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, New Jersey, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia and the District of Columbia. The Company primarily serves telecommunications-intensive business customers such as hotels, universities, financial institutions, professional service firms and practices, hospitals, enhanced service providers, Internet service providers, automobile dealerships and government agencies. US LEC initiated service in North Carolina in March 1997, becoming one of the first competitive local exchange carriers ("CLEC") in North Carolina to provide switched local exchange services.

Business Strategy

US LEC's objective is to be the leading provider of voice, data and Internet services to its existing and target customers, and to increase its market share by expanding its customer base and product portfolio and by providing exceptional customer service. The principal elements of US LEC's business strategy include:

Deploy a Capital-Efficient Network. US LEC utilizes a "smart-build" strategy of owning and deploying switching equipment and leasing the required fiber optic transmission capacity from competitive access providers ("CAPs"), other CLECs or incumbent local exchange carriers ("ILECs"). Management believes the Company's switch-based, leased-transport strategy enables it to enter and penetrate markets, and generate revenue and positive cash flow more rapidly than if the Company first constructed its own transmission facilities. By leasing fiber transport, this smart-build strategy also reduces the up-front capital expenditures required to build a network and enter new markets and avoids the risk of "stranded" investment in under-utilized fiber networks.

Focus of Operations. The Company focuses its network build-out and marketing presence in target markets composed of Tier I cities (major metropolitan areas such as Atlanta, Miami, Washington D.C. and Philadelphia) and Tier II cities (mid-size metropolitan areas such as Greensboro, Tampa and Nashville). The Company has selected its target markets based on a number of considerations, including the number of potential customers and other competitors in such markets and the presence of multiple transmission facility suppliers. The Company currently focuses on markets in the southeast and mid-Atlantic United States. Management believes that the Company's clustered network will enable it to take advantage of customer calling patterns and capture an increasing portion of customer traffic on its network.

Target Telecommunications-Intensive Customers. The Company focuses its sales efforts on telecommunications-intensive business customers including among others, hotels, universities, financial institutions, professional service firms and practices, hospitals, enhanced service providers, Internet service providers, automobile dealerships and government agencies. By focusing on such customers, the Company is able to more efficiently concentrate the telecommunications traffic. In addition, the Company frequently is able to bundle long distance and data services to complement its local services. This further enhances network utilization and thereby improves margins, as fixed network costs are spread over a larger base of services. Unlike some other CLECs, the Company does not resell ILEC dial tone.

Install a Robust Technology Platform. The Company has chosen the 5ESS® Any Media™ digital switch and the CBX500 ATM data switches, both of which are manufactured by Lucent Technologies, Inc. ("Lucent") to provide a consistent technology platform throughout its network. As of December 31, 2001, US LEC had 26 Lucent voice switches and 25 Lucent ATM data switches active throughout its network. To enhance its service offerings, the Company deployed an Alcatel MegaHub® 600ES ("Alcatel") tandem switch in Charlotte. In addition, the Company has also deployed 4 Juniper Networks ® M20 ™ Internet Gateway routers to provide reliable, scalable, and high-speed network elements to significantly enhance the performance of US LEC's Internet access service. The Company has also deployed an Advanced Intelligent Network ("AIN") platform that positions US LEC for enhanced services.

Employ an Experienced Sales Force. Management believes that the Company's success in a particular market is enhanced by employing a direct sales force with extensive local market and telecommunications sales experience. The Company employs this strategy in building its sales force. Salespeople with experience in a particular market provide the Company with extensive knowledge of the Company's target customer base and in many cases have existing relationships with target customers.

Implement Efficient Provisioning Processes with State-of-the-Art Back Office Support. Management believes that a critical aspect of the success of a CLEC is timely and effective provisioning systems, which includes the process of transitioning ILEC or other CLEC customers to the Company's network. The Company focuses on implementing effective and timely provisioning practices to efficiently transition customers from the ILEC or other CLECs to the Company with minimal disruption of the customer's operations. US LEC is approved by Lockheed Martin as a provider of Local Number Portability ("LNP") for its customers. In addition, the US LEC Network Operations Center ("NOC") houses the tools to monitor its network. The NOC provides network surveillance, real-time alarm notification, dispatch services, and 24 hours a day, 7 days a week availability and notification. In 2001, the Company continued its project of upgrading its back office systems by deploying "best of breed" systems for various back office functions. Management believes that the implementation of these or similar systems will enhance the electronic exchange of information within US LEC by providing a centralized view of customer and order tracking data.

Offer a Broad Range of Products and Services. US LEC offers customers a broad range of telecommunication services, which can be bundled. Management believes a broad product range, competitive pricing, and an opportunity to bundle services gives US LEC customers an exceptional value. US LEC offers its customers local access, calling card, enhanced toll-free, digital private line, dedicated high-speed Internet access, frame relay, web hosting, ATM service and long distance service, including intrastate, interstate, international and toll-free. To further the Company's product strategy, US LEC has deployed its ATM and AIN platforms. These systems provide the Company the ability to provide advanced voice and data communications products and services.

Provide Outstanding Customer Service. Management believes that a key element of the success of a CLEC is the ability to satisfy the service needs of its customers. Among other things, the Company must be able to resolve customer issues, promptly implement change requests, resolve billing issues and promptly add additional service and capacity. Management believes that providing customers with outstanding customer care enhances the ability of the Company to retain its customers, as well as attract new customers. Customer care is provided locally by the market-based sales, sales support and operations team and centrally by US LEC's NOC and customer service center.

US LEC'S NETWORK

During 2001, the Company activated additional Lucent switches in Pittsburgh, Pennsylvania, New Orleans, Louisiana, and a second switch in Atlanta, Georgia to bring the network to 26 switching centers. Four of the sites are also long distance platforms that provide additional capability to route and concentrate the Company's long distance traffic.

Calls originating with a US LEC customer are transported over leased lines to the US LEC switch and can either be terminated directly on the Company's network or routed to a long distance carrier, an ILEC or another CLEC, depending on the location of the call recipient. Similarly, calls originating from the public switched telephone network and destined for a US LEC customer are routed through the US LEC switch and delivered to call recipients via leased transmission facilities.

In order to interconnect its switches to the network of the local incumbent phone company and to exchange traffic with it, the Company maintains interconnection agreements with the incumbent carriers. The Telecom Act, decisions of state and federal regulatory bodies and negotiation affect the terms and conditions of the interconnection agreements with the carriers involved. The Company may voluntarily enter into such an agreement, petition a state regulatory commission to arbitrate issues that cannot be resolved by negotiation or by opting into agreements executed by the incumbent and other competitive carriers. The Company has signed or opted into interconnection agreements with all of the incumbent local carriers where it offers services requiring such agreements, including BellSouth Telecommunications, Inc. ("BellSouth"), Verizon Communications Inc. ("Verizon") and Sprint Communications Company L.P. ("Sprint"). (See "Business—Forward Looking Statements and Risk Factors—Existing BellSouth Interconnection Agreements" and "Business—Forward Looking Statements and Risk Factors—Interconnection Agreements")

Products And Services

The Company provides local dial-tone services to customers. Local access is available in many different forms including PRI, T-1 Access and Channel Access. The Company's network is designed to allow a customer to easily increase or decrease capacity and utilize enhanced services as the telecommunications requirements of the customer change. The Company also offers directory assistance and operator services.

US LEC provides long distance services for completing intrastate, interstate and international calls. The Company also provides toll-free services, calling cards and certain enhanced services such as voice mail.

The Company also provides data products including US LECnet (a direct, dedicated, high-speed connection to the Internet), frame relay, ATM service and a number of other services such as email, news feeds and web hosting.

The Company's ability to bundle local, long distance, data and Internet services on the same facility allows it to offer its customers more efficient use of transport facilities, and allows it to aggregate customers' monthly recurring and usage charges on a single consolidated invoice.

During 2000, the Company introduced the ADVANTAGE T, a single-rate, bundled product offering which allows customers to put local, long distance, dedicated high-speed Internet access, digital private line and toll-free services all on a single T-1. Not only can customers choose between multiple products to be carried, but they can also allocate bandwidth dedicated to each product on the T-1. Management believes that this product allows US LEC to expand the total market to which the Company has access.

Most recently, US LEC expanded its data portfolio with the launch of ATM service. This new service allows US LEC's customers to dynamically allocate bandwidth, making the transfer of data communications more efficient and cost-effective. ATM is currently the core technology in the Internet backbone and is widely supported by mainstream CPE (Customer Premise Equipment) manufacturers. US LEC provides the new ATM service from its existing ATM-core data network, and offers customers better control of service costs by allowing them to tailor their traffic speeds and traffic priorities to fit their actual usage patterns. ATM is most suited for companies with larger telecommunication needs, and it allows them to migrate to faster services without significant changes to their equipment.

Sales and Marketing

Sales. US LEC employs a well-trained and experienced direct sales force. The Company recruits salespeople with strong sales backgrounds in its markets, including salespeople from long distance companies, telecommunications equipment manufacturers, network systems integrators, CLECs and ILECs. The Company expanded its quota-bearing sales force from 234 salespeople at December 31, 2000 to 256 salespeople at December 31, 2001. The Company plans to continue to attract and retain highly qualified salespeople by offering them an opportunity to work with an experienced management team in an entrepreneurial environment and to participate in the potential economic rewards made available through a results-oriented compensation program. In 2000, US LEC implemented the Customer Account Manager ("CAM") program in an effort to gain additional sales from current customers and to enhance the Company's relationships with its customer base. The Company also utilizes independent sales agents to identify and maintain customers. During 2001, the Company continued to enhance its sales force by hiring additional quota bearing and sales support staff, continuing education regarding the Company's voice and data products and forming a central group to focus on large sales and data sales.

Marketing. In its existing markets, US LEC seeks to position itself as a high quality alternative to ILECs and other CLECs for local telecommunication services by offering network reliability, bundled products and superior customer support at competitive prices. The Company builds its reputation and brand identity by working closely with its customers to develop services tailored to their particular needs and by implementing targeted product offerings and promotional efforts.

The Company primarily uses two trademarks and service marks: US LEC, and a logo that includes US LEC. These marks have been registered either on the Principal or the Supplemental Register of the United States Patent and Trademark Office for uses related to telecommunications products and services.

Billing. In 2000, the Company migrated its billing function in-house, allowing the Company to realize cost savings and provide additional services to customers. Customer bills are available in a variety of formats to meet a customer's specific needs. US LEC offers customers simplicity and convenience by sending one bill for all services. The Company believes this is an important aspect of customer acquisition and retention.

Employees

As of December 31, 2001, the Company employed 892 people. The Company does not expect significant changes in its staffing level in 2002. The Company considers its employee relations to be very good.

Regulation

The following summary of regulatory developments and legislation does not purport to describe all present and proposed federal, state and local regulations and legislation affecting the telecommunications industry. Other existing federal and state legislation and regulations are currently the subject of judicial proceedings and legislation, legislative hearings and administrative proposals which could change, in varying degrees, the manner in which this industry operates. Neither the outcome of these proceedings and legislation, nor their impact upon the telecommunications industry or the Company, can be predicted at this time. This section also includes a brief description of regulatory and tariff issues pertaining to the operation of the Company.

Overview. The Company's services are subject to varying degrees of federal, state and local regulation. The Federal Communications Commission (the "FCC") generally exercises jurisdiction over the facilities of, and services offered by, telecommunications common carriers that provide interstate or international communications. The state regulatory commissions (herein "PUCs") retain jurisdiction over the same facilities and services to the extent they are used to provide intrastate communications.

Federal Legislation. The Company must comply with the requirements of common carriage under the Communications Act of 1934, as amended (the "Communications Act"). The Telecom Act, enacted on February 8, 1996, substantially revised the Communications Act. The Telecom Act establishes a regulatory framework for the introduction of local competition throughout the United States and was intended to reduce unnecessary regulation to the greatest extent possible. Among other things, the Telecom Act preempts, after notice and an opportunity for comment, any state or local government from prohibiting any entity from providing telecommunications service.

The Telecom Act also establishes a dual federal-state regulatory scheme for eliminating other barriers to competition faced by competitors to the incumbent local exchange carriers and other new entrants into the local telephone market. Specifically, the Telecom Act imposes on ILECs certain interconnection obligations, some of which are implemented by FCC regulations. The Telecom Act contemplates that states will apply the federal regulations and oversee the implementation of all aspects of interconnection not subject to FCC jurisdiction as they oversee interconnection negotiations between ILECs and their new competitors.

The FCC has significant responsibility in the manner in which the Telecom Act will be implemented especially in the areas of pricing, universal service, access charges and price caps. The details of the rules adopted by the FCC will have a significant effect in determining the extent to which barriers to competition in local services are removed, as well as the time frame within which such barriers are eliminated.

The PUCs also have significant responsibility in implementing the Telecom Act. Specifically, the states have authority to establish interconnection pricing, including unbundled loop charges, reciprocal compensation and wholesale pricing consistent with the FCC regulations. The states are also charged under the Telecom Act with overseeing the arbitration process for resolving interconnection negotiation disputes between CLECs and the ILECs and must approve interconnection agreements, and resolve contract compliance disputes arising from interconnection agreements. The Supreme Court is considering cases in which the issue of the PUC's ability to enforce interconnection agreements has been challenged.

The Company has historically earned a significant portion of its revenue from the ILEC in the form of reciprocal compensation payments due to the Company. Several ILECs in the Company's territory (principally BellSouth) have challenged the applicability of the reciprocal compensation related to enhanced service providers and ISP customers receiving more calls than they make. With increasing frequency the ILECs with whom US LEC interconnects (principally BellSouth) have been raising additional objections to their obligations to pay reciprocal compensation, including challenges to the rates at which such payments are calculated and the types of traffic to with the obligations apply (See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Disputed Revenues").

The obligations imposed on ILECs by the Telecom Act to promote competition, such as local number portability, dialing parity, reciprocal compensation arrangements and non-discriminatory access to telephone poles, ducts, conduits and rights-of-way also apply to CLECs, including the Company. As a result of the Telecom Act's applicability to other telecommunications carriers, it may provide the Company with the ability to reduce its own interconnection costs by interconnecting directly with non-ILECs, but may also cause the Company to incur additional administrative and regulatory expenses in responding to interconnection requests. At the same time, the Telecom Act also makes competitive entry into other service or geographic markets more attractive to Regional Bell Operating Companies ("RBOC"), other ILECs, long distance carriers and other companies and has increased and likely will continue to increase the level of competition the Company faces. (See "Business—Competition").

In addition, the Telecom Act provided that ILECs that are subsidiaries of RBOCs could not offer in-region, long distance services across LATAs until they had demonstrated that (i) they have entered into an approved interconnection agreement with a facilities-based CLEC or that no such CLEC has requested interconnection as of a statutorily determined deadline, (ii) they have satisfied a 14-element checklist designed to ensure that the ILEC is offering access and interconnection to all local exchange carriers on competitive terms and (iii) the FCC has determined that in-region, inter-LATA approval is consistent with the public interest, convenience and necessity. The FCC approved Verizon's right to provide interLATA service in Connecticut, New York, Massachusetts, and Pennsylvania and SBC's in Arkansas, Texas, Kansas, Missouri, and Oklahoma. (See "Business — Forward Looking Statements and Risk Factors—Regulation" and "Business — Forward Looking Statements and Risk Factors—Competition").

Federal Regulation And Related Proceedings. The Telecom Act and the FCC's efforts to initiate reform have resulted in numerous legal challenges. As a result, the regulatory framework in which the Company operates is subject to a great deal of uncertainty. Any changes that result from this uncertainty could have a material adverse effect on the Company. The FCC has adopted orders prohibiting the use of tariffs for non-dominant carriers providing international and domestic interstate long distance services. Accordingly, non-dominant interstate services providers and international service providers will no longer be able to rely on the filing of tariffs with the FCC as a means of providing notice to customers of prices, terms, and conditions under which they offer their international and domestic interstate inter-exchange services. The order does not apply to the switched and special access services of the BOCs and other local exchange service providers. The FCC allows permissive detariffing of these services.

The FCC also has proposed reducing the level of regulation that applies to the ILECs, and increasing their ability to respond quickly to competition from the Company and others. For example, in accordance with the Telecom Act, the FCC has applied "streamlined" tariff regulation to the ILECs, which greatly accelerates the time prior to which changes to tariffed service rates may take effect, and has eliminated the requirement that ILECs obtain FCC authorization before constructing new domestic facilities. These actions will allow ILECs to change service rates more quickly in response to competition. Similarly, the FCC has afforded significant new pricing flexibility to ILECs subject to price cap regulation. On August 5, 1999, the FCC adopted an order granting price cap ILECs additional pricing flexibility. The order provides certain immediate regulatory relief regarding price cap ILECs and sets forth a framework of "triggers" to provide those companies with greater flexibility to set rates for interstate access services. On February 2, 2001, the D.C. Circuit upheld the FCC rules regarding pricing flexibility. To the extent such increased pricing flexibility is utilized for ILECs or such additional regulation is implemented, the Company's ability to compete with ILECs for certain service could be adversely affected. The FCC has granted pricing flexibility applications for various interstate access services provided by BOCs in a number of cities, including cities in BellSouth's service territory, including in several of the Company's markets.

On August 8, 1996, the FCC issued an order containing rules providing guidance to the ILECs, CLECs, long distance companies and PUCs regarding several provisions of the Telecom Act. The rules include, among other things, FCC guidance on: (i) discounts for end-to-end resale of ILEC retail local exchange services (which the FCC suggested should be in the range of 17%-25%); (ii) availability of unbundled local loops and other unbundled ILEC network elements; (iii) the use of Total Element Long Run Incremental Costs in the pricing of these unbundled network elements; (iv) average default proxy prices for unbundled local loops in each state; (v) mutual compensation proxy rates for termination of ILEC/CLEC local calls; and (vi) the ability of CLECs and other service providers to opt into portions of previously-approved interconnection agreements negotiated by the ILECs with other parties on a most favored nation (or a "pick and choose") basis. (See "Regulation — Eighth Circuit Court of Appeals Decision and Supreme Court Reversal" for a discussion of the Eighth Circuit Court of Appeals decision related to this order).

On May 8, 1997, the FCC released an order establishing a significantly expanded federal universal service program which subsidized certain eligible services. For example, the FCC established new subsidies for services provided to qualifying schools and libraries with an annual cap of $2.25 billion and for services provided to rural health care providers with an annual cap of $400 million. The FCC also expanded the federal subsidies to low-income consumers and consumers in high-cost areas. Providers of interstate telecommunications service, such as the Company, as well as certain other entities, must pay for these programs. The Company's share of the schools, libraries and rural health care funds is based on its share of the total industry telecommunications service and certain defined telecommunications end user revenues. The Company's share of all other federal subsidy funds is based on its share of the total interstate telecommunications service and certain defined telecommunications end user revenues. Although the Company has made its required contributions to the fund, the amount of the Company's contribution changes each quarter. As a result, the Company cannot predict the effect these regulations will have on the Company in the future. In the May 8 order, the FCC also announced that it will revise its rules for subsidizing service provided to consumers in high cost areas. The United States Court of Appeals for the Fifth Circuit upheld those rules. The FCC has recently initiated rulemaking proceedings to examine various issues on unusual services, including from whom contributions are required and how the contribution is calculated.

In a combined Report and Order and Notice of Proposed Rulemaking released on December 24, 1996, the FCC made changes and proposed further changes in the interstate access charge structure. In the Report and Order, the FCC removed restrictions on an ILEC's ability to lower access prices and relaxed the regulation of new switched access services in those markets where there are other providers of access services. If this increased pricing flexibility is not effectively monitored by federal regulators, it could have a material adverse effect on the Company's ability to compete in providing interstate access services. On May 16, 1997, the FCC released an order revising its access charge rate structure. The new rules substantially increase the costs that ILECs subject to the FCC's price cap rules ("price cap LECs") recover through monthly, non-traffic sensitive access charges and substantially decrease the costs that price cap ILECs recover through traffic sensitive access charges. In the May 16 order, the FCC also announced its plan to bring interstate access rate levels more in line with cost. The plan will include rules to be established that grant price cap LECs increased pricing flexibility upon demonstrations of increased competition (or potential competition) in relevant markets. The manner in which the FCC implements this approach to lowering access charge levels could have a material effect on the Company's ability to compete in providing interstate access services. Several parties have appealed the May 16 order. Those appeals were consolidated and transferred to the United States Court of Appeals for the Eighth Circuit which upheld the Commission's rules.

The FCC has made and is continuing to consider various reforms to the existing rate structure for charges assessed on long distance carriers for allowing them to connect to local networks. These reforms are designed to move these "access charges," over time, to lower, cost-based rate levels and structures. These changes will reduce access charges and will shift charges, which had historically been based on minutes-of-use, to flat-rate, monthly per line charges on end-user customers rather than long distance carriers. On May 31, 2000 the FCC adopted the proposal of the Coalition for Affordable Long Distance Service ("CALLS Order") that significantly restructures and, reduces in some respects, the interstate access charges of the RBOCs, Verizon, AT&T, and Sprint. Among the more significant regulatory changes established by the CALLS Order, the RBOCs and Verizon are required to reduce switched access charges to an average of $0.0055/minute. Price cap ILECs are additionally required to eliminate the pre-subscribed inter-exchange carrier charge ("PICC") as a separate charge and fold it into an increased subscriber line charge ("SLC"). AT&T and Sprint have committed in this proceeding to pass on access charge reductions to consumers, and to eliminate minimum monthly usage charges. Although the CALLS Order will not apply directly to CLECs, ILEC reductions in switched access charges will likely place downward pressure on CLECs, including the Company, to reduce their own switched access charges either in the form of regulatory pressure or commercial pressure from the IXCs. In addition, IXCs other than AT&T and Sprint are not subject to the CALLS Order, but may seek to alter their offerings to conform to AT&T's and Sprint's commitments in this proceeding. A Petition for Reconsideration of the CALLS Order is currently before the FCC. The Order was appealed to the U.S. Court of Appeals for the District of Columbia. The Court remanded the case to the FCC.

On May 21, 2001, the FCC's new rules governing CLEC interstate access charges became effective. The rules establish an initial maximum rate of 2.5 cents per minute for interstate access charges for the first year. In the second year, the rate is reduced to 1.8 cents per minute. In the third year, the rate is further reduced to 1.2 cents per minute. At the end of the third year, the benchmark rate is reduced to the level of the ILEC. A CLEC may not file tariffs for above benchmark rates unless the ILEC in whose territory it operates charges a higher rate, in which case the CLEC may charge the higher ILEC rate or the rate it had tariffed in the previous six months, if lower than the ILEC's rate. A CLEC may charge a rate higher than the benchmark if the IXC, through negotiations, agrees to such higher rate.

In addition, the FCC only allowed a CLEC to charge the benchmark rates in those areas in which the CLEC was actually serving customers on May 21, 2001. In new service areas, the CLEC may only tariff rates as high as the ILEC. Several petitions for reconsideration of the FCC's order were filed with the FCC, as well as appeals to the U.S. Court of Appeals for the District of Columbia Circuit. The Court recently granted the FCC's request to hold the appeals in abeyance until the FCC decides the motions for reconsideration.

In the same order, the FCC determined that a IXCs refusal to serve customers of a CLEC that tariffs the FCC's benchmark rates would generally violate the IXCs duty as a common carrier to provide service was a reasonable decision.

On February 26, 1999, the FCC issued a declaratory ruling and notice of proposed rulemaking concerning ISP traffic. The FCC concluded in its ruling that ISP traffic is jurisdictionally mixed, but largely interstate in nature. The FCC has requested comment as to what reciprocal compensation rules should govern this traffic upon expiration of existing interconnection agreements. The FCC also determined that no federal rule existed that governed reciprocal compensation for ISP traffic at the time existing interconnection agreements were negotiated and concluded that it should permit states to determine whether reciprocal compensation should be paid for calls to ISPs under existing interconnection agreements. The FCC order had been appealed by several parties. On March 24, 2000, the United States Court of Appeals for the D.C. Circuit vacated the FCC's February 26, 1999 declaratory ruling and remanded it to the FCC. The D.C. Circuit Court of Appeals found that the FCC failed to clearly explain and support why ISP traffic should be regulated as long distance traffic rather than as local traffic.

On April 27, 2001, the FCC released its Order on Remand regarding intercarrier compensation for ISP-bound traffic. The FCC asserted exclusive jurisdiction over ISP-bound traffic and established a new interim intercarrier compensation regime for ISP-bound traffic with capped rates above a fixed traffic exchange ratio. Traffic in excess of a ratio of 3:1 (terminating minutes to originating minutes) is presumed to be ISP-bound traffic, and is to be compensated at rates that decrease from $.0015 to $.0007, or the applicable state-approved rate if lower, over three years. Traffic below the 3:1 threshold is to be compensated at the rates in existing and future interconnection agreements. Traffic above the 3:1 ratio is also subject to a growth ceiling using First Quarter 2001 traffic data as the baseline. Traffic in excess of the growth ceiling is subject to "bill and keep," an arrangement in which the originating carrier pays no compensation to the terminating carrier to complete calls. In addition, when a competitive carrier begins to provide service in a state it has not previously served, all traffic in excess of the 3:1 ratio is subject to bill-and-keep arrangements. In exchange for this reduction in reciprocal compensation obligations to CLECs, the ILECs must offer to exchange all traffic subject to Section 251 (b) (5) of the Telecommunications Act of 1996, as well as ISP-bound traffic, at the federal capped rates. It is not possible to estimate the full impact of the FCC Order at this time because the federal regime does not alter existing contracts except to the extent that they incorporate changes of federal law, and because adoption of the federal regime is within the discretion of the ILEC exchanging traffic with CLECs on a state-by-state basis. In addition, the rules are the subject of petitions for reconsideration before the FCC and appeals to the U.S. Court of Appeals for the District of Columbia Circuit. In the event an ILEC determines not to adopt the federal regime, the ILEC must pay the same rate for ISP bound traffic as for calls subject to reciprocal compensation. We cannot predict the impact of the FCC's and the Court's ruling on existing state decisions, the outcome of pending appeals or future litigation on this issue.

The FCC also requires carriers to file periodic reports concerning carriers interstate circuits and deployment of network facilities. The FCC generally does not exercise direct oversight over cost justification and the level of charges for services of non-dominant carriers, although it has the power to do so. The FCC also imposes prior approval requirements on transfers of control and assignments of operating authorizations. The FCC has the authority to generally condition, modify, cancel, terminate, or revoke operating authority for failure to comply with federal laws or rules, regulations and policies of the FCC. Fines or other penalties also may be imposed for such violations. Although the Company believes it is in compliance with all applicable laws and regulations, there can be no assurance that the FCC or third parties will not raise issues with regard to the Company's compliance with such laws and regulations.

Eighth Circuit Court Of Appeals Decisions And The Supreme Court Reversal. Various parties, including ILECs and state PUCs, requested that the FCC reconsider its own rules and/or filed appeals of the FCC's August 8, 1996 order.

The U.S Court of Appeals for the Eighth Circuit ("8th Circuit") held that, in general, the FCC does not have jurisdiction over prices for interconnection, resale, leased unbundled network elements ("UNEs") and traffic termination. The 8th Circuit also overturned the FCC's "pick and choose" rules as well as certain other FCC rules implementing the Telecom Act's local competition provisions. In addition, the 8th Circuit decisions substantially limited the FCC's authority to enforce the local competition provisions of the Telecom Act. On January 25, 1999, U.S. Supreme Court reversed the 8th Circuit and upheld the FCC's authority to issue regulations governing pricing of unbundled network elements provided by the ILECs in interconnection agreements (including regulations governing reciprocal compensation). In addition, the Supreme Court affirmed the "pick and choose" rules which allows carriers to choose individual portions of existing interconnection agreements with other carriers and to opt-in only to those portions of the interconnection agreement that they find most attractive. The Supreme Court did not, however, address other challenges raised about the FCC's rules at the 8th Circuit because the 8th Circuit did not decide those challenges. In addition, the Supreme Court disagreed with the standard applied by the FCC for determining whether an ILEC should be required to provide a competitor with particular unbundled network elements. On remand, the FCC largely retained its list of unbundled elements, but eliminated the requirement that ILECs provide unbundled access to local switching for customers with four or more lines in the top 50 MSAs, and the requirement to provide unbundled operator service and directory assistance.

On July 18, 2000, the 8th Circuit issued its order concerning the issues left unresolved by the Supreme Court. It vacated the FCC's rules regarding the discount on retail services that ILECs must provide to CLECs, the costing rules that must be applied in determining the price of unbundled network elements from ILECs, and the requirement that ILECs must provision combinations of UNEs that are not already combined. The Supreme Court is expected to rule on these cases by June 2002. It is not possible to predict the outcome of that decision. The Company does not currently purchase or provision UNEs, and does not anticipate any adverse effects as a result of the regulation of these two services.

The 8th Circuit decisions and the reversal by the Supreme Court continue to create uncertainty about the rules governing pricing terms and conditions of interconnection agreements. This uncertainty makes it difficult to predict whether the Company will have the ability to negotiate acceptable interconnection agreements in the future should the Company decide to resell ILEC services or purchase or provision UNEs.

In August 1998, the FCC determined that high-speed wire-line data services are telecommunications services subject to regulation under Sections 251 and 252 of the Telecom Act. In the same order, the FCC issued a notice of proposed rulemaking on terms for the provision of such services on a separate subsidiary basis. Permitting ILECs to provision data services through separate affiliates with fewer regulatory requirements could have a material adverse impact on the Company's ability to compete in the data services sector. The FCC imposed conditions on the merger of SBC with Ameritech in October 1999 that permit the provisioning of high-speed wire-line data services via separate subsidiaries pursuant to various requirements. The D.C. Circuit vacated the separate subsidiary requirement on January 9, 2001. The Company cannot predict whether these requirements will ultimately prove enforceable, nor whether they will deter anti-competitive conduct if they are enforceable. The FCC has initiated rulemaking proceedings to consider whether advanced services offered by ILECs should be regulated as services offered by a dominant or nondominant carrier. If the service offerings are deemed nondominant, the ILEC will be subject to licensed regulation. In a related proceeding, the FCC is seeking to determine whether advanced services are information services and what regulations should apply, if that is the case. A finding that advanced services are information services, and not telephone services, could result in significantly lower levels of regulation. The Company cannot predict the outcome of these proceedings.

Slamming. The FCC and many state PUCs have implemented rules to prevent unauthorized changes in a customer's pre-subscribed local and long distance carrier (a practice commonly known as "slamming.") Pursuant to the FCC's slamming rules, a carrier found to have slammed a customer is subject to substantial fines. In addition, the FCC's slamming rules were revised effective November 2000 to include new provisions governing liability for slamming, and provisions allowing state PUCs to elect to administer and enforce the FCC's slamming rules. These slamming liability rules substantially increase a carrier's possible liability for unauthorized carrier changes, and may substantially increase a carrier's administrative costs in connection with alleged unauthorized carrier changes (even if the carrier can provide valid proof that such changes were authorized). Although the Company cannot predict the effect that these new liability rules will have on its business, because virtually all of the Company's customers are connected on a dedicated basis to US LEC's network, it is unlikely that the Company will incur any significant liability under these new rules. The FCC also issued revised rules in August 2000 that are expected to become effective in April 2001 or shortly thereafter, regarding the procedures for changing a subscriber's pre-subscribed carrier, and establishing new carrier reporting and registration requirements. Implementation of these new rules may increase the Company's costs of administering long distance service accounts.

The Communications Assistance for Law Enforcement Act ("CALEA") provides rules to ensure that law enforcement agencies would be able to conduct properly authorized electronic surveillance of digital and wireless telecommunication services. CALEA requires telecommunications carriers to modify their equipment, facilities, and services used to provide telecommunications services to ensure that they are able to comply with authorized electronic surveillance requirements. For circuit-switched facilities, carriers were required to complete these modifications by June 30, 2001. Carriers providing packet-switched services were required to comply by November 19, 2001. The deadline for carrier compliance with certain additional requirements has been extended by the FCC until June 30, 2002. US LEC's network is CALEA compliant.

State Regulation. The Company has all of the certifications necessary to offer its current services in the states of:

State
North Carolina
Alabama
Mississippi
Kentucky
Maryland
Pennsylvania
Delaware
District of Columbia
New Jersey
Louisiana
Georgia
Virginia
Indiana
New York
Ohio
Connecticut
Massachusetts
Tennessee
South Carolina
Florida

There are no applications for certification currently pending before any PUC or the FCC.

To the extent that an area within a state in which the Company operates is served by a small (in line counts) or rural ILEC not currently subject to competition, the Company generally does not have authority to service those areas at this time. Most states regulate entry into local exchange and other intrastate service markets, and states' regulation of CLECs vary in their regulatory intensity. The majority of states mandate that companies seeking to provide local exchange and other intrastate services apply for and obtain the requisite authorization from the PUC. This authorization process generally requires the carrier to demonstrate that it has sufficient financial, technical, and managerial capabilities and that granting the authorization will serve the public interest.

As a CLEC, the Company is subject to the regulatory directives of each state in which the Company is certified. In addition to tariff filing requirements, most states require that CLECs charge just and reasonable rates and not discriminate among similarly situated customers. Some states also require the filing of periodic reports, the payment of various regulatory fees and surcharges, and compliance with service standards and consumer protection rules. States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of a CLEC. States generally retain the right to sanction a carrier or to revoke certifications if a carrier violates relevant laws and/or regulations.

In all of the states where US LEC is certified, the Company is required to file tariffs or price lists setting forth the terms, conditions and/or prices for services which are classified as intrastate. In some states, the Company's tariff may list a range of prices or a ceiling price for particular services, and in others, such prices can be set on an individual customer basis, although the Company may be required to file tariff addenda of the contract terms. The Company is not subject to price cap or to rate of return regulation in any state in which it currently provides services. Some states where the Company operates have adopted de-tarriffing rules

As noted above, the states have the primary regulatory role over intrastate services under the Telecom Act. The Telecom Act allows state regulatory authorities to continue to impose competitively neutral and nondiscriminatory requirements designed to promote universal service, protect the public safety and welfare, maintain the quality of service and safeguard the rights of consumers. PUCs will implement and enforce most of the Telecom Act's local competition provisions, including those governing the specific charges for local network interconnection. In some states, those charges are being determined by generic cost proceedings and in other states they are being established through arbitration proceedings. Depending on how such charges are ultimately determined, such charges could become a material expense to the Company.

Competition

ILECs. In each market served by its networks, the Company faces, and expects to continue to face, significant competition from the ILECs, which currently dominate their local telecommunications markets as a result of their historic monopoly position.

The Company competes with the ILECs in its markets for local exchange services on the basis of product offerings, bundling, reliability, state-of-the-art technology, price, network design, ease of ordering and customer service. However, the ILECs have long-standing relationships with their customers and provide those customers with various transmission and switching services, a number of which the Company does not currently offer. In addition, ILECs enjoy a competitive advantage due to their vast financial resources. The Company has sought, and will continue to seek, to achieve parity with the ILECs in order to become able to provide a full range of local telecommunications services. (See "Business — Regulation" for additional information concerning the regulatory environment in which the Company operates.) Because US LEC leases fiber optic transmission capacity to link its customers with its networks, and uses state-of-the-art technology in its switch platforms, the Company has demonstrated cost and service quality advantages over some currently available ILEC networks.

Other CLECs. In every market where US LEC has a switching center, one or more other CLECs are also operating. In some cases, the Company competes head-to-head with other CLECs and in some cases the other CLECs seek to serve a different customer base. The Company competes with other CLECs in its markets on the basis of product offerings, bundling, reliability, state-of-the-art technology, price, network design, ease of ordering and customer service.

Other Competitors. The Company also faces, and expects to continue to face, competition from other potential competitors in certain of the markets in which the Company offers its services. In addition to the ILECs and other CLECs, potential competitors capable of offering switched local and long distance services include long distance carriers, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end-users. Many of these potential competitors enjoy competitive advantages based upon existing relationships with subscribers, brand name recognition and vast financial resources. A continuing trend toward business combinations and alliances in the telecommunications industry may create significant new competitors to the Company.

The Company believes that the Telecom Act, as well as a recent series of completed and proposed transactions between ILECs and long distance companies and cable companies, increase the likelihood that barriers to local exchange competition will be removed. The Telecom Act, as passed, conditioned the provision of in-region interLATA services by RBOCs upon a demonstration that the market in which an RBOC seeks to provide such services has been opened to competition. When ILECs that are RBOC subsidiaries are permitted to provide such services they will be in a position to offer single source service which will represent a significant competitive challenge for the Company. ILECs that are not RBOC subsidiaries may offer single source service presently. The Telecom Act's limitations on provision of in-region interLATA services have been challenged by the RBOCs. (See "Business—Regulation").

The Company also competes with long distance carriers in the provision of long distance services. Although the long distance market is dominated by a few major competitors, hundreds of other companies also compete in the long distance marketplace.

Forward Looking Statements and Risk Factors

Except for historical statements and discussions, statements contained in this report constitute "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In addition, the Company's Annual Report to Stockholders for the year ended December 31, 2001, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and subsequently filed Annual Reports on Form 10-K, may include forward looking statements. Other written or oral statements which constitute forward looking statements have been made and may in the future be made by or on behalf of US LEC. These statements are identified by the use of forward-looking terminology such as "believes," "expects," "may," "will," "should," "estimates" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. These forward looking statements are based on a number of assumptions concerning future events, including the outcome of judicial and regulatory proceedings, the adoption of balanced and effective rules and regulations by the FCC and PUCs, and US LEC's ability to successfully execute its strategy. These forward looking statements are also subject to a number of uncertainties and risks, many of which are outside of US LEC's control, that could cause actual results to differ materially from such statements. These risks include, but are not limited to, the following:

Disputed Revenues. The deregulation of the telecommunications industry, the implementation of the Telecom Act, and the distress of many carriers in the wake of the downturn in the telecommunications industry have embroiled numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company.

These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, rates applicable to different categories of traffic, and the characterization of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations, and proceedings over these and other material issues (see "Management's Discussion and Analysis of Financial Condition and Results of Operation—Disputed Revenues"). The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of operations.

Risks Associated with Strategy. The operation, construction, expansion and development of US LEC's operations depend on, among other things, the Company's ability to continue to (i) accurately assess potential new markets and products, (ii) identify, hire and retain qualified personnel, (iii) lease access to suitable fiber optic transmission facilities, (iv) install and operate switches and related equipment and (v) obtain any required government authorizations, all in a timely manner, at reasonable costs and on satisfactory terms and conditions. In addition, US LEC has experienced rapid growth since its inception, and management believes that sustained growth will place a strain on operational, human and financial resources. The Company's ability to manage its operations and expansion effectively depends on the continued development of plans, systems and controls for its operational, financial and management needs. There can be no assurance that the Company will be able to satisfy these requirements or otherwise manage its operations and growth effectively. The failure of US LEC to satisfy these requirements could have a material adverse effect on the Company's financial condition and its ability to fully implement its operating plans.

The Company's growth strategy also involves the following risks:

Qualified Personnel. A critical component for US LEC's success is hiring and retaining additional qualified managerial, sales and technical personnel. Since its inception, the Company has experienced significant competition in hiring and retaining personnel possessing necessary skills and telecommunications experience. Although management believes the Company has been successful in hiring and retaining qualified personnel, there can be no assurance that US LEC will be able to do so in the future.

Switches and Related Equipment. An essential element of the Company's current strategy is the provision of switched local service. There can be no assurance that the switches and associated equipment necessary to operate the Company's network will not experience technological or operational problems that cannot be resolved in a satisfactory or timely matter. The failure of the Company to operate successfully switches and other network equipment could have a material adverse effect on the Company's financial condition and its ability to attract and retain customers or to enter additional markets.

Interconnection Agreements. The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, the Company will be required to negotiate extension or replacement agreements. There can be no assurance that the Company will successfully negotiate such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company. The Company has signed interconnection agreements with various ILECs, including BellSouth, Sprint, Verizon and other carriers. These agreements provide the framework for the Company to serve its customers when other local carriers are involved. The Company has signed multiple agreements with BellSouth which govern relationships in all nine states (See existing BellSouth Interconnection Agreements above).

Ordering, Provisioning And Billing. The Company has developed processes and procedures and is working with external vendors, including the ILECs, in the implementation of customer orders for services, the provisioning, installation and delivery of such services and monthly billing for those services. The failure to effectively manage processes and systems for these service elements or the failure of the Company's current vendors or the ILECs to deliver ordering, provisioning and billing services on a timely and accurate basis could have a material adverse effect upon the Company's ability to fully execute its strategy.

Products and Services. The Company currently offers local, long distance, data, Internet and enhanced services. In order to address the needs of its target customers, the Company will be required to emphasize and develop additional products and services. No assurance can be given that the Company will be able to provide the range of telecommunication services that its target customers need or desire.

Acquisitions. US LEC may acquire other businesses as a means of expanding into new markets or developing new services. The Company is unable to predict whether or when any prospective acquisitions will occur or the likelihood of a material transaction being completed on favorable terms and conditions. Such transactions would involve certain risks including, but not limited to, (i) difficulties assimilating acquired operations and personnel; (ii) potential disruptions of the Company's ongoing business; (iii) the diversion of resources and management time; (iv) the possibility that uniform standards, controls, procedures and policies may not be maintained; (v) risks associated with entering new markets in which the Company has little or no experience; and (vi) the potential impairment of relationships with employees or customers as a result of changes in management. If an acquisition were to be made, there can be no assurance that the Company would be able to obtain the financing to consummate any such acquisition on terms satisfactory to it or that the acquired business would perform as expected.

Dependence on Key Personnel. The Company's business is managed by a small number of executive officers, most notably, Francis J. Jules, Chief Executive Officer, Aaron D. Cowell, Jr., President and Chief Operating Officer and Michael K. Robinson, Executive Vice President and Chief Financial Officer. The loss of the services of one or more of these key people could materially and adversely affect US LEC's business and its prospects. The Company does not maintain key man life insurance on any of its officers. The competition for qualified managers in the telecommunications industry is intense. Accordingly, there can be no assurance that US LEC will be able to hire and retain necessary personnel in the future to replace any of its key executive officers, if any of them were to leave US LEC or be otherwise unable to provide services to US LEC.

Reliance on Leased Capacity. A key element of US LEC's business and growth strategy is leasing fiber optic transmission capacity instead of constructing its own transport facilities. In implementing this strategy, the Company relies upon its ability to lease capacity from CAPs, other CLECs and ILECs operating in its markets. In order for this strategy to be successful, the Company must be able to negotiate and renew satisfactory agreements with its fiber optic network providers, and the providers must process provisioning requests on a timely basis, maintain their networks in good working order and provide adequate capacity at competitive prices. Although US LEC enters into agreements with its network providers that are intended to ensure access to adequate capacity and timely processing of provisioning requests and although US LEC's interconnection agreements with ILECs generally provide that the Company's connection and maintenance orders will receive attention at parity with the ILECs and other CLECs and that adequate capacity will be provided, there can be no assurance that the ILECs and other network providers will comply with their contractual (and, in the case of the ILECs, legally required) network provisioning obligations, or that the provisioning process will be completed for the Company's customers on a timely and otherwise satisfactory basis. Furthermore, there can be no assurance that the rates to be charged to US LEC under future interconnection agreements or lease agreements with other providers will allow the Company to offer usage rates low enough to attract a sufficient number of customers and operate its networks at satisfactory margins.

Competition. The telecommunications industry is highly competitive. In each of the Company's existing and target markets, the Company competes and will continue to compete principally with the ILECs serving that area. ILECs are established providers of local telephone and exchange access services to all or virtually all telephone subscribers within their respective service areas. ILECs also have greater financial and personnel resources, brand name recognition and long-standing relationships with customers and with regulatory authorities at the federal and state levels and with most long distance carriers.

The Company also faces, and expects to continue to face, competition from other current and potential market entrants, including long distance carriers seeking to enter, reenter or expand entry into the local exchange marketplace, and from other CLECs, CAPs, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end-users. In addition, a continuing trend toward combinations and strategic alliances in the telecommunications industry could give rise to significant new competitors. Many of these current and potential competitors have financial, personnel and other resources, including brand name recognition, substantially greater than those of the Company, as well as other competitive advantages over the Company.

The Company also competes with long distance carriers in the provisioning of long distance services. Although the long distance market is dominated by few major competitors, hundreds of other companies also compete in the long distance marketplace.

In addition, the regulatory environment in which the Company operates is undergoing significant change. As this regulatory environment evolves, changes may occur which could create greater or unique competitive advantages for all or some of the Company's current or potential competitors, or could make it easier for additional parties to provide services. (See "Business—Competition").

At December 31, 2001, the Company was providing services to over 6,800 customers. A key element of the Company's future success will depend on its ability to retain these customers and minimize loss of revenue associated with customer or product churn. While the Company has historically achieved significant success in retaining customers, competition in the Company's marketplace is intense and the Company anticipates that other carriers will seek to persuade the Company's customers to switch service provided for some or all of their products.

Regulation. Although passage of the Telecom Act has resulted in increased opportunities for companies that are competing with the ILECs, no assurance can be given that changes in current or future regulations adopted by the FCC or state regulators or other legislative or judicial initiatives relating to the telecommunications industry would not have a material adverse effect on the Company. In addition, although the Telecom Act, as passed, conditions RBOCs' provisioning of in-region long distance service on a showing that the local market has been opened to competition, in the event a RBOC has satisfied these conditions, it could (i) remove the incentive RBOCs presently have to cooperate with companies like US LEC to foster competition within their service areas so that they can qualify to offer in-region long distance by allowing RBOCs to offer such services immediately and (ii) give the RBOCs the ability to offer "one-stop shopping" for both long distance and local service.

In addition to the specific concerns regarding the RBOCs ability to provide in-region long distance, the regulatory environment facing the Company is subject to numerous uncertainties. The FCC and PUC orders that were designed to implement the Telecom Act have been challenged in numerous proceedings. As a result, the Company must attempt to execute its business strategy without knowing the rules that will govern its operations and its dealings with other telecommunications companies including the rates and terms under which it may charge other carriers for reciprocal compensation and other access charges. Even though a number of the past regulatory efforts by the FCC and PUCs are or have been challenged, the Company expects further rule making from the FCC and PUCs. The outcome of these challenges and the nature and scope of future rule making are unknown. In particular, the Company anticipates further efforts by other carriers, primarily ILECs and IXCs, at the FCC, PUC and in legislative initiatives to seek to cap, reduce and/or eliminate reciprocal compensation and to cap or significantly reduce other access charges. The Company cannot predict the degree to which the ILECs and IXCs will be successful in such efforts, or, if they are, when such changes will take effect. If such changes result in a significant decrease in the rates which the Company may charge other carriers for reciprocal compensation and access or if such changes are retroactive, such changes could have a material adverse effect on the Company.

As the regulatory environment changes, it is possible that the Company's strategy and its execution of the strategy may not be the optimal choice. Any such changes could also result in additional, unanticipated expenses. There can be no assurances that regulatory change will not have a material and adverse effect on the Company. (See "Business—Regulation").

Legal Proceedings. The Company is currently involved in arbitral, administrative and judicial proceedings and appeals thereof to collect amounts owed to the Company by other carriers, primarily BellSouth, Verizon and Sprint. The Company cannot predict when these matters will be formally resolved and, although Management anticipates that these pending actions and appeals will be resolved favorably, no assurance can be given that the Company will be ultimately successful in these actions or the appeals thereof or that the Company will collect all amounts that it believes to be due it from these other carriers, or that if it does collect some or all of the award due to it, when payment of the awards will be received (see Management's Discussion and Analysis of Financial Condition and Results of Operations—Disputed Revenues").

Future Capital and Operating Requirements. Implementation of the Company's business strategy will require significant capital and operating expenditures during 2002 and future years. In December 1999, the Company amended its senior secured credit facility increasing the amount available under the facility to $150 million (the "Credit Facility"). At December 31, 2001, all $150 million was borrowed. In April 2000, the Company completed a transaction with affiliates of Bain Capital, Inc. and Thomas H. Lee Partners, L.P. to invest $200 million in convertible preferred stock of US LEC (the "Preferred Stock Investment"). (See "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources"). The Company's principal capital expenditures relate to the expansion of its switching platform, related infrastructure and facilities. Management expects to satisfy its capital and operating requirements primarily with current cash balances, and cash flow from operations, although there can be no assurance that the actual expenditures required to implement the Company's business strategy will not exceed amounts available from these sources. In addition, the actual amount and timing of the Company's future expenditures may differ materially from the Company's estimates as a result of, among other things, the number of its customers and the services for which they subscribe and regulatory, technological and competitive developments in the Company's industry. Due to the uncertainty of these factors, actual revenues and costs may vary from expected amounts, possibly to a material degree, and such variations are likely to affect the implementation of the Company's business strategy.

The Company also will continue to evaluate revenue opportunities in existing and other markets as well as potential acquisitions. The Company expects to obtain the capital required to pursue additional opportunities from current cash balances, additional borrowings, the sale of additional equity or debt securities or cash generated from operations. In light of the risk factors discussed herein, there can be no assurance, however, that the Company will be successful in raising sufficient additional capital on acceptable terms or that the Company's operations will produce sufficient positive cash flow to pursue such opportunities should they arise. Failure to raise and generate sufficient funds, or unanticipated increases in capital requirements may require the Company to delay or curtail its expansion plans, which could have a material adverse effect on the Company's growth and its ability to compete in the telecommunications services industry.

Executive Officers of the Registrant

The following table sets forth certain information regarding the executive officers of US LEC Corp:

Name	Age	Position
Richard T. Aab	53	Chairman of the Board and Director
Tansukh V. Ganatra	58	Director, Former Vice Chairman and Chief Executive Officer until his retirement in December 2001
Francis J. Jules	45	Chief Executive Office as of December 2001
Aaron D. Cowell, Jr.	39	President, Chief Operating Officer and General Counsel
Michael K. Robinson	45	Chief Financial Officer and Executive Vice President

Richard T. Aab co-founded US LEC in June 1996 and has served as Chairman of the Board of Directors since that time. He also served as Chief Executive Officer from June 1996 until July 1999. Between 1982 and 1997, Mr. Aab held various positions with ACC Corp., an international telecommunications company in Rochester, NY, including Chairman and Chief Executive Officer, and served as a director.

Tansukh V. Ganatra co-founded US LEC in June 1996 and has served as a director since that time. He served as Chief Executive Officer and Vice Chairman of the Board of Directors from July 1999 until his retirement in December 2001. He also served as President and Chief Operating Officer from June 1996 until July 1999. From 1987 to 1997, Mr. Ganatra held various positions with ACC Corp., including serving as its President and Chief Operating Officer. Prior to joining ACC Corp., Mr. Ganatra held various positions during a 19-year career with Rochester Telephone Corp., culminating with the position of Director of Network Engineering. Mr. Ganatra currently serves as a consultant to US LEC Corp.

Francis J. Jules joined US LEC as Chief Executive Officer and as a Director in December 2001 with more than 20 years of data, communications and Internet industry experience. He served as president of Winstar Communications, Inc. ("Winstar") from August 2000 to December 2001 at which time he was named Chief Executive Officer. Mr. Jules served as president of SBC/Ameritech Business Communications Services ("SBC/ Ameritech") from October 1997 to August 2000. Prior to joining SBC/Ameritech, he held senior management positions with Northern Telecom (now Nortel), IBM and New York Telephone.

Aaron D. Cowell, Jr. has been involved in numerous operating areas of the Company's business and legal affairs since 1996, including its IPO in April 1998. Mr. Cowell joined US LEC in June 1998 as executive vice president and general counsel. Later that year, he assumed responsibility for US LEC's sales and field sales support functions. In 1999, his executive management duties were expanded to include US LEC's engineering, operations, regulatory, customer care services and marketing departments. Mr. Cowell was appointed as president and chief operating officer of US LEC in 2000. He also holds a position on the Executive Committee for ALTS (The Association for Local Telecommunications Services), through which he helps promote regulations and decisions that will facilitate fair competition in the telecommunications industry. Before joining US LEC in 1998, Mr. Cowell spent 11 years with Moore & Van Allen PLLC, a large Southeastern law firm, where he represented, among others, US LEC and Alcatel, primarily in corporate finance and merger and acquisition matters. Mr. Cowell is a graduate of Harvard Law School and Duke University.

Michael K. Robinson has been US LEC's executive vice president of finance and chief financial officer since July 1998. Prior to joining US LEC, Mr. Robinson held positions with the telecommunications division of Alcatel, an international telecommunications equipment company headquartered in Paris, France. From 1996 to July 1998, Mr. Robinson was executive vice president and chief financial officer of Alcatel Data Networks, a developer and manufacturer of wide area network data switching equipment for carrier and enterprise solutions. He was responsible for financial controls, treasury, contracts management, information systems, and facilities. In addition to his duties at Alcatel Data Networks, Mr. Robinson was responsible for the worldwide financial operations of the enterprise and data networking division of Alcatel. From 1989 to 1995, Mr. Robinson was vice president and chief financial officer of Alcatel Network Systems, which developed, manufactured, and marketed transmission equipment for telecommunications systems. Prior to joining Alcatel, Mr. Robinson held various management positions with Windward International and Siecor Corp. Mr. Robinson holds a masters degree in business administration from Wake Forrest University.

ITEM 2. PROPERTIES

The Company's corporate headquarters are located at its principal office at Morrocroft III, 6801 Morrison Blvd., Charlotte, NC 28211. The Company leases all of its administrative and sales offices and its switch sites. The various leases expire during years through 2016. Most of these leases have renewal options. Additional office space and switch sites will be leased or otherwise acquired as the Company's operations and networks are expanded and as new networks are constructed.

ITEM 3. LEGAL PROCEEDINGS

US LEC is not currently a party to any material legal proceedings, other than proceedings, arbitrations, and any appeals thereof, related to reciprocal compensation, intercarrier access and other amounts due from other carriers. The Company believes it will be largely successful in these proceedings, and that any adverse ruling in any pending proceeding or arbitration will not have a material adverse effect on the Company (see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Disputed Revenues").

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDER MATTERS

No matters were submitted to a vote of security holders during the quarter ending December 31, 2001.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDERS

The Company's common stock trades on The Nasdaq National Market under the symbol CLEC. As of March 21, 2002, US LEC Corp. had approximately 5,895 beneficial holders of its common stock. Of that total, 145 were stockholders of record. To date, the Company has not paid cash dividends on its common stock. The Company currently intends to retain earnings to support operations and finance expansion and therefore does not anticipate paying cash dividends in the foreseeable future. In addition, both the credit facility and the preferred stock agreements contain certain limitations on the payment of dividends.

The following table sets forth the high and low closing price information as reported by Nasdaq during the period indicated since the Company's Class A Common Stock began trading publicly on April 24, 1998.

	Stock Price*	
1998	**High**	**Low**
First Quarter	N/A	N/A
Second Quarter	$27.00	$15.00
Third Quarter	$25.88	$ 7.31
Fourth Quarter	$14.81	$ 9.50
1999	**High**	**Low**
First Quarter	$19.50	$13.38
Second Quarter	$24.62	$16.50
Third Quarter	$33.13	$22.75
Fourth Quarter	$32.25	$23.50
2000	**High**	**Low**
First Quarter	$46.31	$28.88
Second Quarter	$33.64	$15.94
Third Quarter	$17.00	$ 7.56
Fourth Quarter	$11.22	$ 3.50
2001	**High**	**Low**
First Quarter	$ 9.06	$ 4.69
Second Quarter	$ 6.50	$ 2.28
Third Quarter	$ 4.01	$ 2.32
Fourth Quarter	$ 6.75	$ 2.73

*No public market for the stock prior to April 24, 1998

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

SELECTED FINANCIAL DATA

For the years ended December 31,1997, 1998, 1999, 2000 and 2001
(In Thousands, Except Per Share Data and Operating Data, as noted below)

	1997	1998	1999	2000	2001
Statement of Operations:					
Revenue, Net	$ 6,458	$ 84,716	$175,180	$ 114,964	$178,602
Cost of Services	4,201	33,646	73,613	52,684	90,298
Gross Margin	2,257	51,070	101,567	62,280	88,304
Selling, General and Administrative	6,117	25,020	48,375	80,684	114,898
Depreciation and Amortization	443	4,941	11,720	24,365	35,103
Loss on Resolution of Disputed Revenue*	—	—	—	55,345	—
Provision (Recovery) for Disputed Receivables*	—	—	—	40,000	(7,042)
Earnings (Loss) from Operations	(4,303)	21,109	41,472	(138,114)	(54,655)
Interest Income (Expense), Net	(355)	1,623	(2,046)	(3,005)	(8,699)
Earnings (Loss) before Income Taxes	(4,658)	22,732	39,426	(141,119)	(63,354)
Income Taxes Provision (Benefit)	—	9,305	15,617	(23,727)	—
Net Earnings (Loss)	(4,658)	13,427	23,809	(117,392)	(63,354)
Less: Dividends on Preferred Stock	—	—	—	8,758	12,810
Less: Accretion of Preferred Stock Issuance Cost	—	—	—	336	491
Net Earnings (Loss) Attributable to Common Shareholders	$(4,658)	$ 13,427	$ 23,809	$(126,486)	$(76,655)
Net Earnings (Loss) Per Share-Basic	$ (0.25)	$ 0.53	$ 0.87	$ (4.58)	$ (2.83)
Net Earnings (Loss) Per Share-Diluted	$ (0.25)	$ 0.52	$ 0.84	$ (4.58)	$ (2.83)
Weighted Average Shares Outstanding-Basic	18,653	25,295	27,431	27,618	27,108
Weighted Average Shares Outstanding-Diluted	18,653	25,804	28,411	27,618	27,108
Other Financial Data:					
Capital Expenditures	$13,055	$ 47,292	$ 57,396	$ 109,740	$ 40,425
Net Cash Flow Used in Operating Activities	(5,594)	(19,143)	(25,935)	(49,319)	(5,971)
Net Cash Flow Used in Investing Activities	(5,951)	(48,538)	(49,696)	(111,743)	(40,425)
Net Cash Flow Provided in Financing Activities	14,008	106,457	48,840	251,709	21,077
Operating Data:					
Number of States Served	1	4	7	12	13
Number of Local Switches	3	11	16	23	26
Number of Customers	142	558	1,946	3,929	6,823
Number of Employees	78	253	460	816	892
Number of Sales and Sales Related Employees	24	98	180	330	365
Balance Sheet Data:					
Working Capital (Deficit)	$(2,269)	$ 76,215	$113,109	$ 112,402	$ 59,972
Accounts Receivable, Net	6,006	66,214	193,943	61,165	42,972
Current Assets	9,656	112,184	213,269	160,782	135,644
Property and Equipment, Net	12,889	56,219	102,002	188,052	188,436
Total Assets	22,681	170,203	320,100	373,159	333,313
Long-Term Debt (including current portion)	5,000	20,000	72,000	130,000	150,000
Series A Redeemable Convertible Preferred Stock	—	—	—	202,854	216,155
Total Stockholders' Equity (Deficiency)	5,757	112,975	138,870	(22,250)	(97,325)

*See Note 6 of the Company's Consolidated Financial Statements for the period ended December 31, 2001.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Except for the historical information contained herein, this report contains forward-looking statements, subject to uncertainties and risks, including the demand for US LEC's services, the ability of the Company to introduce additional products, the ability of the Company to successfully attract and retain personnel, competition in existing and potential additional markets, uncertainties regarding its dealings with ILECs and other telecommunications carriers and facilities providers, regulatory uncertainties, and the possibility of adverse decisions related to reciprocal compensation and access charges owing to the Company by other carriers. These and other applicable risks are summarized in the "Forward-Looking Statements and Risk Factors" section and elsewhere in the Company's Annual Report on Form 10-K for the period ended December 31, 2001, and in other reports which are on file with the Securities and Exchange Commission.

The following discussion and analysis should be read in conjunction with the "Selected Consolidated Financial Data" on page 23 of this report and the Company's consolidated financial statements and related notes thereto appearing elsewhere in this report.

Company Overview

US LEC is a rapidly growing switch-based competitive local exchange carrier ("CLEC") that provides integrated telecommunications services to its customers, including local and long distance voice services, toll free services, frame relay, high speed internet, ATM and web hosting. The Company primarily serves telecommunication-intensive business customers including hotels, universities, financial institutions, professional service firms, hospitals, and Internet service providers ("ISPs"). US LEC was founded in June 1996 after passage of the Telecommunications Act of 1996 (the "Telecom Act"), which enhanced the competitive environment for local exchange services. US LEC initiated service in North Carolina in March 1997, becoming one of the first CLECs in North Carolina to provide switched local exchange services. US LEC currently offers service to customers in selected markets in North Carolina, Florida, Georgia, Tennessee, Virginia, Alabama, Washington D.C., Pennsylvania, New Jersey, Mississippi, Maryland, South Carolina, Louisiana and Kentucky. In addition, US LEC is currently certified to provide telecommunication services in Indiana, Delaware, New York, Ohio, Texas, Connecticut and Massachusetts. As of December 31, 2001, US LEC's network was comprised of 26 Lucent 5ESS® AnyMedia™ digital switches, 25 Lucent CBX500 ATM data switches and 4 Juniper M20™ Internet Gateway routers that are located throughout the Southeast and mid-Atlantic states, in addition to an Alcatel MegaHub® 600ES switch in Charlotte, North Carolina.

Revenue and Cost of Services

US LEC's revenue is comprised of two primary components: (1) fees paid by end customers for local, long distance, data, Internet and enhanced services, and (2) carrier access charges, including reciprocal compensation, which is discussed below. Local, long distance, data, Internet and enhanced service revenue is comprised of monthly recurring charges, usage charges, and initial non-recurring charges. Monthly recurring charges include the fees paid by customers for facilities (lines and trunks) in service and additional features on those facilities. Usage charges consist of usage-sensitive fees paid for calls made. Initial non-recurring charges consist primarily of installation charges. Access charges are comprised of charges paid primarily by inter-exchange carriers ("IXCs") for the origination and termination of inter-exchange toll and toll-free calls and reciprocal compensation, which is discussed below. The Company does not resell any ILEC dial tone.

Reciprocal compensation arises when a local exchange carrier completes a call that originated on another local exchange carrier's network. Reciprocal compensation rates are fixed by an interconnection agreement executed between those carriers. In 2001, 2000 and 1999, 8%, 11% and 80% of the Company's revenue was recognized from reciprocal compensation and was being disputed by the incumbent local exchange carriers, primarily BellSouth. The dispute primarily arose from reciprocal compensation charges related to traffic that was terminated to enhanced service providers, including internet service providers. On October 3, 2001, the Company and BellSouth entered into a settlement agreement by which they resolved outstanding reciprocal receivables owed the Company by BellSouth. (See Disputed Revenue appearing below.)

Although the Company generated a majority of its revenue from reciprocal compensation prior to 2000, US LEC was founded to establish a company that would provide a wide array of telecommunications services to its customers. US LEC has deployed a significant regional network, and as of December 2001 has active switches in 26 sites, serving over 6,800 medium to large size business customers. Management believes this customer base, achieved in less than five years, is indicative of the market's acceptance of US LEC's strategy and service offerings. Management expects the Company's end customer revenue to continue to increase and carrier access revenue to continue to decrease as percentages of total revenue in future periods as US LEC continues to deploy its network and expand its customer base, and as carrier access rates decline due primarily from rate reductions in new agreements entered into by the Company with ILECs and to regulatory and legislative actions. During 2001, access charges represented approximately 39% of the Company's revenue.

In order to interconnect its switches to the network of the local incumbent phone company and to exchange traffic with it, the Company executes interconnection agreements with the incumbent carriers. The terms and conditions of the interconnection agreements are effected by the Telecom Act, decisions of state and federal regulatory bodies and negotiation with the carriers involved. The Company may voluntarily enter into such an agreement, petition a state regulatory commission to arbitrate issues that can not be resolved by negotiation or by opting into agreement executed by the incumbent and other competitive carriers. The Company has signed or opted into interconnection agreements with all of the incumbent local carriers where it offers services requiring such agreements (See "Business—Forward Looking Statements and Risk Factors—Interconnection Agreements, and—Disputed Revenues").

In 2000, the Company began deferring installation revenue from end customers and from other carriers. The Company is amortizing this revenue over the average life of these contracts. As of December 31, 2001 and 2000, the Company had $3.8 and $2.1 million, respectively, recorded as deferred installation revenue, including $1.4 and $0.6 million, respectively, recorded as current liabilities.

In 2000, the Company began deferring installation charges from ILECs related to Network and end customer Facilities. The Company is amortizing these costs over the average life of these contracts. During the years ended December 31, 2001 and 2000, the Company amortized $2.0 and $0.6 million, respectively, of deferred installation charges into Cost of Services. As of December 31, 2001 and 2000, the Company had $3.0 million and $1.7 million recorded in Other Assets on its Consolidated Balance Sheet, respectively.

The Company's cost of services is comprised primarily of two types of charges: leased transport charges which comprise approximately three-fourths of the Company's cost of services and usage sensitive charges (primarily usage charges associated with the Company's off-net toll and toll-free services and access and reciprocal compensation charges owing to other carriers) which comprise approximately one-fourth of the Company's cost of services. The Company's leased transport charges are the lease payments incurred by US LEC for the transmission facilities used to connect the Company's customers to its switch and to connect to the ILEC and other carrier networks. US LEC, as part of its "smart-build" strategy, does not currently own any fiber or copper transport facilities. These facilities are leased from various providers including, in many cases, the ILEC. The Company's strategy of leasing rather than building its own fiber transport facilities results in the Company's cost of services being a significant component of total costs. Management believes that this strategy has several benefits, including faster time-to-market, more efficient asset utilization, and diverse interconnection opportunities. The Company has to date been successful in negotiating lease agreements which generally match in the aggregate the duration of its customer contracts, thereby allowing the Company to mitigate the risk of incurring charges associated with transmission facilities that are not being utilized by customers.

Selling, General and Administrative Expenses; Depreciation and Amortization

In addition to the costs of services described above, the Company incurs certain other expenses. The largest component of selling, general and administrative expense ("SG&A") relates to employee salaries, related taxes and benefits, and other incentive-based compensation. During 2001 these categories represented 63% of total SG&A expense. Other major categories of SG&A include expenses associated with leasing real estate for the Company's offices and switching centers, insurance, travel, supplies, legal and accounting.

Depreciation and amortization expense is primarily due to capital expenditures made by the Company. Gross property, plant and equipment increased from $118.5 million in 1999, to $228.0 million in 2000 and to $262.2 million in 2001. Depreciation and amortization expense increased from $11.7 million in 1999 to $24.4 million in 2000 and to $35.1 million in 2001.

As the Company continues to expand its network and grow its customer base, SG&A and depreciation and amortization expense is expected to continue to grow, but decline as a percentage of revenue.

Stockholders' Deficiency

In 2000, additional paid-in-capital was reduced by approximately $36.0 million representing amounts due from Metacomm, which is indirectly controlled by Richard T. Aab, the Company's Chairman and largest stockholder. Due to Mr. Aab's controlling position in both Metacomm and the Company, this amount was treated for financial reporting purposes as a deemed distribution to the stockholder.

On March 31, 2001, the Company, Richard T. Aab, and Tansukh V. Ganatra, the Company's former Vice Chairman and former Chief Executive Officer, reached an agreement in principle to effect a recapitalization of the Company and to resolve Mr. Aab's commitment that Metacomm would fully satisfy its obligations to the Company for facilities, advances and interest. This transaction was closed on August 6, 2001. Under the agreement, the following events occurred: (1) Mr. Aab made a contribution to the capital of the Company by delivering to the Company for cancellation 2 million shares of Class B Common Stock, (2) Mr. Aab and Mr. Ganatra converted all of the then remaining and outstanding shares of Class B Common Stock—a total of approximately 14 million such shares were outstanding after the 2 million shares were cancelled—into the same number of shares of Class A Common Stock, (3) the Company agreed to indemnify Mr. Aab for certain adverse tax effects, if any, relating to the Company's treatment in its balance sheet of the amount of the Metacomm obligation as a distribution to shareholder and (4) the Company agreed to indemnify Mr. Ganatra for certain adverse tax effects, if any, from the conversion of his Class B shares to Class A shares.

As required by the agreement, the Company obtained a valuation by a qualified valuation firm approved by the Company's audit committee that the delivery of the 2 million shares of Class B Common Stock and the conversion of the approximately 14 million shares of Class B Common Stock into the same number of shares of Class A Common Stock resulted in the realization by the Company and its Class A shareholders of value approximately equal to the outstanding Metacomm obligation, received a favorable tax opinion, and received certain consents.

As a result of this transaction, the number of issued and outstanding shares of Common Stock (Class A and Class B together) decreased by 2 million and, as a result of the elimination of the 10-vote-per-share Class B Common Stock, Mr. Aab no longer holds shares representing a majority of the voting power of the Company's outstanding common stock.

Results of Operations

Comparison of Year Ended December 31, 2001 to Year Ended December 31, 2000

Net revenue increased to $178.6 million for the year ended December 31, 2001, from $115.0 million in 2000. The significant increase in revenue resulted from an increase in the total number of customers in existing markets and an increase in telecommunications traffic on its network. In 2001, the Company's end customer revenue increased to $93.8 million or 53% of total revenue from $54.2 million or 47% of total revenue in 2000.

The loss on the resolution of disputed revenue in 2000 was a result of an order issued by the North Carolina utilities commission on March 31, 2000 (the "March 31 NCUC Order") that relieved BellSouth from paying reciprocal compensation to US LEC for any minutes of use attributable to the network operated by Metacomm, a customer of BellSouth and US LEC, or any similar network. As a result of this order, the Company recorded a pre-tax non-recurring non-cash charge of $55.3 million in the first quarter of 2000. This charge was composed of the write-off of approximately $153.0 million in receivables related to reciprocal compensation revenue offset by a previously established allowance of $39.0 million, and a reduction of approximately $59.0 million in reciprocal compensation commissions payable to Metacomm.

The Company recorded a significant charge relating to disputed receivables in the fourth quarter of 2000. The $52.0 million provision is netted on the Company's consolidated statement of operations against a $12.0 million reduction in commissions payable on those receivables, resulting in the $40.0 million provision on the Company's consolidated statement of operations. Management believed that this charge was necessary due to the uncertainty related to current regulatory proceedings related to reciprocal compensation and other access charges and the continued refusal by ILECs, principally BellSouth, to pay amounts believed by the Company to be owed to it under applicable interconnection agreements and due to Sprint's failure to pay US LEC's access charges. The Company resolved its disputes with both BellSouth and Sprint during 2001. Included in the consolidated statements of operations is an amount approximating $7.0 million, representing a net recovery of amounts previously recorded as reserves for disputed receivables and certain other related accruals (see Disputed Revenue below).

Cost of services is comprised primarily of leased transport, facility installation, and usage charges. Cost of services increased to $90.3 million, or 50% of revenue for 2001 from $52.7 million, or 45% of revenue, for 2000. This increase in cost of services was primarily a result of the increase in the size of US LEC's network, an increase in customers and usage by its customers, as well as a shift to lower margin end customer revenue.

Selling, general and administrative expenses for the year ended December 31, 2001 increased to $107.9 million, or 60% of revenue, compared to $80.7 million, or 70% of revenue, for the year ended December 31, 2000. This increase was primarily a result of costs associated with developing and expanding the infrastructure of the Company as it expands into new markets and adds products, such as expenses associated with personnel, sales and marketing, occupancy, administration and billing, as well as legal expenses associated with litigation. The decrease in selling, general and administrative expenses as a percentage of revenue in 2001 was primarily due to expense control, an improvement in back office efficiencies and growth in end customer revenue.

Depreciation and amortization for 2001 increased to $35.1 million from $24.4 million in 2000 primarily due to the increase in depreciable assets in service related to US LEC's network expansion.

Interest income for 2001 decreased to $3.2 million from $4.8 million in 2000. The decrease in interest income in 2001 was primarily due to a decline in cash available for investing and declining rates of return on invested funds.

Interest expense for 2001 increased to $11.9 million from $7.8 million in 2000. This increase in interest expense was primarily due to increased borrowings under the Company's credit facility partially offset by declining interest rates.

For the year ended December 31, 2001, the Company did not record an income tax expense or benefit, compared to a $23.7 million income tax benefit in 2000. In 2001, the income tax benefit, primarily created from operating losses, was offset by increases in the tax valuation allowance. The $23.7 million benefit for the year ended December 31, 2000 is net of an increase of $35.7 million in the valuation allowance against deferred tax assets relating to the anticipated use of federal and state net operating losses.

Net loss for 2001 amounted to $63.4 million, compared to a net loss of $117.4 million for 2000. Dividends paid in kind and accrued on Series A Mandatorily Redeemable Convertible Preferred Stock for the year ended December 31, 2001 and 2000 amounted to $12.8 million and $8.8 million, respectively (See Note 5 of the Company's consolidated financial statements). The accretion of preferred stock issuance cost was $0.5 million and $0.3 million for the years ended December 31, 2001 and 2000, respectively.

As a result of the foregoing, net loss attributable to common shareholders for the year ended December 31, 2001 amounted to $ 76.7 million or ($2.83) per diluted share as compared to $126.5 million, or ($4.58) per diluted share for 2000. The decrease in net loss and net loss per share is attributed to the factors discussed above.

Comparison of Year Ended December 31, 2000 to Year Ended December 31, 1999

Net revenue decreased to $115.0 million for the year ended December 31, 2000, from $175.2 million in 1999. The significant decrease in revenue resulted from the elimination of reciprocal compensation revenue related to Metacomm and a reduction of local interconnect rates, partially offset by the Company's expansion into new markets, an increase in the total number of customers in existing markets and an increase in telecommunications traffic on its network. The Company recorded a $27.8 million reduction against reciprocal compensation revenue and related receivables for the year ended December 31, 1999 due to the judicial and regulatory proceedings related to this disputed revenue and management's assessment that the collectibility of such revenue was not assured. As of December 31, 1999, the total allowance offsetting the disputed receivables totaled $39.8 million. Unless otherwise specified, the results of operations reflected in this report are net of these and other normal operating adjustments (See Disputed Revenue below).

The loss on the resolution of disputed revenue was a result of the March 31, 2000 NCUC Order that relieved BellSouth from paying reciprocal compensation to US LEC for any minutes of use attributable to the network operated by Metacomm, a customer of BellSouth and US LEC, or any similar network. As a result of this order, the Company recorded a pre-tax non-recurring non-cash charge of $55 million in the first quarter of 2000. This charge is composed of the write-off of approximately $153 million in receivables related to reciprocal compensation revenue offset by a previously established allowance of $39 million, and a reduction of approximately $59 million in reciprocal compensation commissions payable to Metacomm.

The Company recorded a significant charge relating to disputed receivables in the fourth quarter of 2000. The $52 million provision is netted on the Company's Consolidated Statement of Operations against a $12 million reduction in commissions payable on those receivables, resulting in the $40 million provision on the Company's Consolidated Statement of Operations. Management believes this charge was necessary due to the uncertainty related to current regulatory proceedings related to reciprocal compensation and other access charges and the continued refusal by ILECs, principally BellSouth, to pay amounts believed by the Company to be owed to it under applicable interconnection agreements and due to Sprint's failure to pay US LEC's access charges (see Disputed Revenue below).

Cost of services is comprised primarily of leased transport, facility installation, and usage charges. In 1999, cost of services also included commissions payable to Metacomm on reciprocal compensation revenue. Cost of services decreased from $73.6 million, or 42% of revenue, for 1999 to $52.7 million, or 45% of revenue, for 2000. This decrease in cost of services was primarily a result of the decrease in local interconnect rates and the elimination of commissions payable to Metacomm on reciprocal compensation revenue, partially offset by the increase in the size of US LEC's network, and increase usage by its customers other than Metacomm. The increase in cost of services as a percentage of revenue was due to the increase of core revenue as a percentage of total revenue and the one-time costs associated with entering several new markets.

Selling, general and administrative expenses for the year ended December 31, 2000 increased to $80.7 million, or 70% of revenue, compared to $48.4 million, or 28% of revenue, for the year ended December 31, 1999. This increase was primarily a result of costs associated with developing and expanding the infrastructure of the Company as it expanded into new markets and added products, such as expenses associated with personnel, sales and marketing, occupancy, administration and billing, as well as legal expenses associated with litigation. The increase in selling, general and administrative expenses as a percentage of revenue in 2000 was primarily due to the reduction in reciprocal compensation revenue.

Depreciation and amortization for 2000 increased to $24.4 million from $11.7 million in 1999 primarily due to the increase in depreciable assets in service related to US LEC's network expansion.

Interest income for 2000 increased to $4.8 million from $1.1 million in 1999. The increase in interest income in 2000 was primarily due to the investing of a portion of the proceeds from the issuance of Series A Mandatorily Redeemable Convertible Preferred Stock on April 11, 2000.

Interest expense for 2000 increased to $7.8 million from $3.1 million in 1999. This increase in interest expense was primarily due to increased borrowings under the Company's credit facility and an increase in interest rates.

For the year ended December 31, 2000, the Company recorded a $23.7 million income tax benefit, compared to $15.6 million in expense in 1999. The $23.7 million benefit for the year ended December 31, 2000 is a net amount which includes a $35.7 million valuation allowance against deferred tax assets relating to the anticipated use of federal and state net operating losses.

Net loss for 2000 amounted to $117.4 million, compared to net earnings of $23.8 million for 1999. Dividends paid in kind and accrued on Series A Mandatorily Redeemable Convertible Preferred Stock for the year ended December 31, 2000 amounted to $8.8 million (See Note 5 of the Company's Consolidated Financial Statements). The accretion of preferred stock issuance cost was $0.3 million for the year ended December 31, 2000.

As a result of the foregoing, net loss attributable to common shareholders for the year ended December 31, 2000 amounted to $126.5 million, or ($4.58) per share (diluted), compared to net earnings of $23.8 million, or $0.84 per share (diluted) for 1999. The increase in net loss and net loss per share is attributed to the factors discussed above.

Liquidity and Capital Resources

US LEC's business is capital intensive and its operations require substantial capital expenditures for the expansion of its network switches, related electronic equipment, information systems and facilities. The Company's cash capital expenditures were $40.4 and $111.6 million for the years ended December 31, 2001 and 2000, respectively. As of December 31, 2001, the outstanding amount under the Company's senior secured credit facility was $150.0 million. While management believes the $80.5 million in cash at December 31, 2001 will fund the Company's capital requirements until it becomes EBITDA positive, funding to free cash flow may require additional financing.

On April 11, 2000, the Company issued $200 million of its Series A Mandatorily Redeemable Convertible Preferred Stock to affiliates of Bain Capital, Inc. ("Bain") and Thomas H. Lee Partners, L.P. ("THL"). See Note 5 to the Company's Consolidated Financial Statements for a description of this transaction and the terms of the Preferred Stock. Proceeds to the Company, net of commissions and other transaction costs, were approximately $193.7 million.

Cash used in operating activities was approximately $5.9 million in 2001 compared to $49.3 million in 2000. The decrease in cash used in operating activities was primarily due to the collection of amounts due from BellSouth for reciprocal compensation, facility charges, and other charges and amounts due from Sprint for access charges. The Company received payment of approximately $50.0 million from BellSouth and Sprint during 2001 as a result of its settlements with both companies over disputed revenues (see Disputed Revenue below).

Cash used in investing activities decreased to $40.5 million in 2001 from $111.7 million in 2000. The investing activities are related to purchases of switching and related telecommunications equipment, office equipment and leasehold improvements associated with the Company's expansion into additional locations and markets primarily during 2000. This decrease is evidence that the network build-out is substantially complete and capital spending is success based, as well as continued control of new expenditures.

Cash provided by financing activities decreased to $21.1 million in 2001 from $251.7 million for 2000 due to increased borrowings under the credit facility and the issuance of preferred stock in 2000. In 2000, the Company issued $200.0 million in Series A Mandatorily Redeemable Convertible Preferred Stock (see above). Proceeds from borrowings, net of repayments, under the Company's credit facility decreased during 2001.

The Company's credit facility is subject to certain financial covenants, measured quarterly, the most significant of which relates to the achievement of increasing levels of revenue and earnings, and debt ratios. The Company was in compliance with these covenants as of the quarter ended December 31, 2001. Company management believes it will be in compliance with all quarterly financial covenants during 2002 based upon projected operating results. These projected operating results are dependent upon the Company meeting quarterly 2002 targets of new customers, existing customer retention, customer usage and billing rates, and as a result involve some degree of uncertainty. Should any of these assumptions not be achieved for a particular quarter, it is possible that a financial covenant will not be met during 2002. Although there can be no assurances, Company management believes if this were to occur, it would be able to obtain the necessary waivers or amendments from its lenders. The Company was successful in obtaining an amendment in the third quarter of 2001 relating to its minimum quarterly EBITDA financial covenant.

The following table provides a summary of the Company's contractual obligations and commercial commitments. Additional detail about these items is included in the notes to the consolidated financial statements.

		Payments Due by Period			
	Total	**Less than 1 year**	**1-3 years**	**4-5 years**	**After 5 years**
Contractual Obligations					
Long-term debt	$150,000	$18,750	$100,000	$31,250	$ —
Operating leases	53,802	7,708	19,300	10,332	16,462
Total contractual cash obligations	$203,802	$26,458	$119,300	$41,582	$16,462

Disputed Revenues

The deregulation of the telecommunications industry, the implementation of the Telecom Act, and the distress of many carriers in the wake of the downturn in the telecommunications industry have embroiled numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company. These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, rates applicable to different categories of traffic, and the characterization of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations, and proceedings over these and other material issues. The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of its operations.

Reciprocal Compensation—On April 27, 2001, the Federal Communications Commission ("FCC") released an Order on Remand and Report and Order (the "Remand Order") addressing inter-carrier compensation for traffic terminated to Internet service providers ("ISPs"). The interpretation and enforcement of the Remand Order will likely be the most important factor in the Company's efforts to collect reciprocal compensation for ISP-bound traffic in the future. In the Remand Order, the FCC addressed a number of important issues, including the rules under which carriers are to compensate each other for traffic terminated to ISPs and the rates applicable for ISP-bound traffic as well as traffic bound to other customers.

Importantly, while the Remand Order provides greater certainty about the Company's right to bill for traffic terminated to ISPs, the effect of the Remand Order on the Company will depend on how it is interpreted and enforced. In particular, there are uncertainties as to whether the Remand Order has any effect on the Company's pending arbitral, commission and judicial proceedings seeking to collect compensation for traffic terminated to ISPs; whether certain provisions of the Remand Order will be applied state-by-state, market-by-market and/or carrier-by-carrier; whether the limitations on growth of ISP traffic in the Remand Order will survive legal challenge; whether the Remand Order will satisfy the U.S. District Court of the District of Columbia on whose order the FCC issued the Remand Order; and whether the incumbent carrier will trigger the rate reductions and other limitations set forth in the Remand Order. If the Remand Order is interpreted in a manner adverse to the Company on all or any of the issues, or if the Remand Order is modified as a result of pending or new legal challenges, it could have a material adverse effect on the Company. For a more complete description of the Remand Order see "Business – Regulation".

On October 3, 2001 the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which they resolved outstanding reciprocal compensation receivables in the various states in which both operate and other past payments. BellSouth agreed to pay US LEC approximately $31.0 million, in addition to approximately $10.0 million it paid in August 2001, to resolve those issues for periods prior to the effective date of the Remand Order. The Settlement Agreement imposed on the parties certain obligations regarding the payment of reciprocal compensation in the future, which are in the process of being implemented. The Settlement Agreement also provides that the payments made for periods prior to the effective date of the Remand Order are not subject to adjustment as a result of subsequent changes in the Remand Order.

In September 2001, the Company filed a proceeding with the Virginia State Corporation Commission ("VSCC") and the FCC seeking to collect reciprocal compensation from Verizon owing for traffic bound for ISPs as well as other customers. The VSCC declined jurisdiction over the dispute. In October 2001, the FCC has accepted jurisdiction over the dispute. The Company cannot predict when the FCC will take action on this dispute or whether the Company will ultimately be successful in full; however, management believes that it will be largely successful in recovering amounts owed by Verizon in light of the Remand Order.

Disputed Access Revenues—A number of IXCs have refused to pay access charges to CLECs, including the Company, alleging that the access charges exceed the rates charged by the ILEC. Currently there are a number of court cases, regulatory proceedings at the FCC, and legislative efforts involving such challenges. The Company cannot predict the outcome of these cases, regulatory proceedings, and legislative efforts or their impact on access rates.

On April 27, 2001, the FCC released its Seventh Report and Order and Further Notice of Proposed Rulemaking (the "Access Order") in which it established a benchmark rate at which a CLEC's interstate access charges will be presumed to be reasonable and which CLECs may impose on IXCs by tariff. The Access Order addresses a number of issues important to how CLECs charge IXCs for originating and terminating interstate toll and toll free traffic.

The Access Order should provide certainty as to the Company's right to bill IXCs for interstate access at rates above those tariffed by the ILECs. Notwithstanding the apparent certainty created by the Access Order, its effect on the Company will depend on how the Access Order is interpreted and enforced and the outcome of appeals currently pending. If the Access Order is interpreted or enforced in a manner adverse to the Company as it relates to periods prior to the effective date, such result could have a material adverse effect on the Company. For a more complete description of the Access Order, see "Business—Regulation".

On May 30, 2001, the FCC issued a decision in *AT&T Corp. v. Business Telecom Inc.* (the "BTI Decision"), in which the FCC determined that the interstate access rates charged by Business Telecom, Inc. ("BTI") were not just and reasonable. The FCC determined that just and reasonable rates for BTI were properly based upon the lowest band of rates charged by the National Exchange Carriers Association ("NECA"). The FCC based this holding on the limited evidence before it, tending to show that BTI's operations were similar to those of small, urban ILECs, many of whom charge the lowest band NECA rates. BTI settled its appeal of the BTI Decision. As with the Access Order described above, the BTI Decision's effect on the Company will depend on how the order is interpreted and enforced. If the BTI Decision is interpreted or enforced in a manner adverse to the Company, such result could have a material adverse effect on the Company.

By settlement dated October 5, 2001, Sprint and the Company resolved their dispute over access charges. Sprint paid the Company approximately $8.0 million, in addition to approximately $1.5 million it paid in the four months preceding the settlement, in payment of past due invoices for periods through July 2001.

Legislation—Periodically, legislation has been introduced in the U.S. House of Representatives or the U.S. Senate to alter or amend the Telecom Act. It is the Telecom Act which opened the local telephone markets for competition and outlines many of the ground rules pursuant to which the ILECs and the CLECs operate with respect to each other. The Company anticipates that additional efforts will be made to alter or amend the Telecom Act. The Company cannot predict whether any particular piece of legislation will become law and how the Telecom Act might be modified. The passage of legislation amending the Telecom Act could have a material adverse effect on the Company and its financial results.

Interconnection Agreements with ILECs—The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has installed a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, it will be required to negotiate extension or replacement agreements. There can be no assurance that the Company will successfully negotiate or obtain such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company.

Interconnection with Other Carriers—The Company anticipates that as its interconnections with various carriers increase, the issue of seeking compensation for the termination or origination of traffic whether by reciprocal arrangements, access charges or other charges will become increasingly complex. The Company does not anticipate that it will be cost effective to negotiate agreements with every carrier with which the Company exchanges originating and/or terminating traffic. The Company will make a case-by-case analysis of the cost effectiveness of committing resources to these interconnection agreements or otherwise billing and paying such carriers.

Significant Accounting Policies

Revenue Recognition—The Company recognizes revenue on telecommunications and enhanced communications services in the period that the service is provided. Revenue is recognized when earned based upon the following specific criteria: (1) persuasive evidence of arrangement exists (2) services have been rendered (3) seller's price to the buyer is fixed or determinable and (4) collectibility is reasonably assured. Reciprocal compensation that is earned as revenue from other local exchange carriers represents compensation for local telecommunications traffic terminated on our network that originates on another carrier's network.

The Company's cost of services is comprised primarily of two types of charges: leased transport charges which comprise approximately three quarters of the Company's cost of services and usage sensitive charges (primarily usage charges associated with the Company's off net toll and toll free services and access and reciprocal compensation charges owing to other carriers) which comprise approximately one-quarter of the Company's cost of services. The Company's leased transport charges are the lease payments incurred by US LEC for the transmission facilities used to connect the Company's customers to the Company owned switch that services that customer and to connect to the ILEC and other carrier networks. US LEC, as part of its "smart-build" strategy, does not currently own any fiber or copper transport facilities. These facilities are leased from various providers including, in many cases, the ILEC.

Effect of Recently Issued Accounting Pronouncements

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities by requiring that entities recognize all derivatives as either assets or liabilities at fair market value on the balance sheet. The Company believes that the adoption of SFAS No. 133 will not have a material effect on its results of operations as it does not currently hold any derivative instruments or engage in hedging activities.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS 121, "Accounting for Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed of", but retains many of its fundamental provisions, expands the scope of discontinued operations to included more disposal transactions. SFAS No. 144 will be effective for the Company for financial statements issued for the fiscal year beginning January 1, 2002. The Company has evaluated the effect the statement will have on its consolidated financial statements and related disclosures and does not believe that the effect will be material.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

US LEC is exposed to various types of market risk in the normal course of business, including the impact of interest rate changes on its investments and debt. As of December 31, 2001, investments consisted primarily of institutional money market funds. All of the Company's long-term debt consists of variable rate instruments with interest rates that are based on a floating rate which, at the Company's option, is determined by either a base rate or the London Interbank Offered Rate, plus, in each case, a specified margin.

Although US LEC does not currently utilize any interest rate management tools, it will evaluate the use of derivatives such as, but not limited to, interest rate swap agreements to manage its interest rate risk. As the Company's investments are all short-term in nature and its long-term debt is at variable short-term rates, management believes the carrying values of the Company's financial instruments approximate fair values.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders of
US LEC Corp.
Charlotte, North Carolina

We have audited the accompanying consolidated balance sheets of US LEC Corp. and subsidiaries (the "Company") as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity (deficiency) and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of US LEC Corp. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche LLP

Charlotte, North Carolina
February 21, 2002

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands)

	December 31, 2001	December 31, 2000
ASSETS		
Current Assets		
Cash and cash equivalents	$ 80,502	$105,821
Restricted cash	1,300	1,300
Accounts receivable (net of allowance of $12,263 and $1,523 at December 31, 2001 and 2000, respectively)	42,972	48,859
Deferred income taxes	1,840	—
Prepaid expenses and other assets	9,030	4,802
Total current assets	135,644	160,782
Property and Equipment, Net	188,436	188,052
Accounts Receivable (net of an allowance of $52,000 at December 31, 2000)	—	12,306
Deferred Income Taxes	—	4,148
Other Assets	9,233	7,871
Total Assets	$ 333,313	$373,159
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
Current Liabilities		
Accounts payable	$ 10,747	$ 13,684
Accrued network costs	17,877	9,302
Commissions payable	6,679	7,012
Accrued expenses—other	14,928	10,884
Deferred revenue	6,691	3,350
Deferred income taxes	—	4,148
Long-term debt—current portion	18,750	—
Total current liabilities	75,672	48,380
Long-Term Debt	131,250	130,000
Commissions Payable	—	9,860
Deferred Income Taxes	1,840	—
Other Liabilities	5,721	4,315
Commitments and Contingencies (Note 6)		
Series A Mandatorily Redeemable Convertible Preferred Stock (10,000 authorized shares, 222 and 209 shares issued and outstanding with redemption values of $222 and $209 at December 31, 2001 and 200, respectively) (Note 5)	216,155	202,854
Stockholders' Deficiency		
Common stock-Class A, $.01 par value (122,925 authorized shares, 26,388 and 10,934 outstanding at December 31, 2001 and 2000, respectively)	264	109
Common stock-Class B, $.01 par value (17,075 authorized shares, 0 and 16,835 outstanding at December 31, 2001 and December 2000, respectively) (Note 10)	—	168
Additional paid-in capital (Note 10)	76,421	73,813
Retained deficit	(172,777)	(96,121)
Unearned compensation — stock options	(1,233)	(219)
Total stockholders' deficiency	(97,325)	(22,250)
Total Liabilities and Stockholders' Deficiency	$ 333,313	$373,159

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2001, 2000, and 1999
(In Thousands, Except Per Share Data)

	2001	2000	1999
Revenue, Net (Notes 2, 6 and 8—includes related party transactions totaling $9,511 in 1999)	$178,602	$ 114,964	$175,180
Cost of Services (Notes 2, 6 and 8—includes related party transactions totaling $38,990 in 1999, respectively)	90,298	52,684	73,613
Gross Margin	88,304	62,280	101,567
Selling, General and Administrative Expenses	114,898	80,684	48,375
Loss on Resolution of Disputed Revenue (Note 2)	—	55,345	—
(Recovery) Provision for Disputed Receivables, Net (Note 2)	(7,042)	40,000	—
Depreciation and Amortization	35,103	24,365	11,720
(Loss) Earnings from Operations	(54,655)	(138,114)	41,472
Other (Income) Expense			
Interest Income	(3,171)	(4,834)	(1,050)
Interest Expense (Note 4)	11,870	7,839	3,096
(Loss) Earnings Before Income Taxes	(63,354)	(141,119)	39,426
Income Tax Provision (Benefit) (Note 7)	—	(23,727)	15,617
Net (Loss) Earnings	(63,354)	(117,392)	23,809
Less: Preferred Stock Dividends (Note 5)	12,810	8,758	—
Less: Accretion of Preferred Stock Issuance Cost (Note 5)	491	336	—
Net (Loss) Earnings Attributable to Common Stockholders	$ (76,655)	$(126,486)	$ 23,809
Net (Loss) Earnings Per Common Share (Note 11):			
Basic	$ (2.83)	$ (4.58)	$ 0.87
Diluted	$ (2.83)	$ (4.58)	$ 0.84
Weighted Average Number of Shares Outstanding (Note 11):			
Basic	27,108	27,618	27,431
Diluted	27,108	27,618	28,411

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIENCY)

For the years ended December 2001, 2000 and 1999

(In Thousands)

	Common Stock Class A		Common Stock Class B		Additional Paid-In Capital	Retained Earnings (Deficit)	Unearned Compensation Stock Options	Total
Balance, December 31, 1998 ...	10,345	$103	17,076	$ 171	$106,800	$ 6,556	$ (655)	$ 112,975
Exercise of stock options	14	—	—	—	103	—	—	103
Exercise of warrants	5	—	—	—	14	—	—	14
Tax effects related to stock options and warrants	—	—	—	—	28	—	—	28
Issuance of Shares	62	1	—	—	1,749	—	—	1,750
Unearned compensation— stock options	—	—	—	—	(29)	—	220	191
Net earnings	—	—	—	—	—	23,809	—	23,809
Balance, December 31, 1999 ...	10,426	104	17,076	171	108,665	30,365	(435)	138,870
Exercise of stock options	28	—	—	—	286	—	—	286
Exercise of warrants	131	1	—	—	372	—	—	373
Tax effects related to stock options and warrants	—	—	—	—	228	—	—	228
Issuance of shares	108	1	—	—	442	—	—	443
Unearned compensation— stock options	—	—	—	—	(65)	—	216	151
Accretion of preferred stock issuance cost	—	—	—	—	—	(336)	—	(336)
Conversion of Class B Common Shares to Class A Common Shares	241	3	(241)	(3)	—	—	—	—
Deemed distribution to related party	—	—	—	—	(36,115)	—	—	(36,115)
Preferred Stock Dividends ...	—	—	—	—	—	(8,758)	—	(8,758)
Net loss	—	—	—	—	—	(117,392)	—	(117,392)
Balance, December 31, 2000 ...	10,934	$109	16,835	$ 168	$ 73,813	(96,121)	$ (219)	(22,250)
Exercise of stock options	2	1	—	—	7	(1)	—	7
Issuance of Shares	618	6	—	—	1,413	—	—	1,419
Unearned compensation— stock options	—	—	—	—	1,460	—	(1,014)	446
Accretion of preferred stock issuance cost	—	—	—	—	—	(491)	—	(491)
Conversion of Class B Common Shares to Class A Common Shares and effects of recapitalization	14,834	148	(16,835)	(168)	20	—	—	—
Preferred Stock Dividends ...	—	—	—	—	—	(12,810)	—	(12,810)
Recapitalization fees	—	—	—	—	(292)			(292)
Net loss	—	—	—	—	—	(63,354)	—	(63,354)
Balance, December 31, 2001 ...	26,388	$264	—	$ —	$ 76,421	$(172,777)	$(1,233)	$ (97,325)

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	2001	2000	1999
Operating Activities			
Net (loss) earnings	$ (63,354)	$(117,392)	$ 23,809
Adjustments to reconcile net (loss) earnings to net cash used in operating activities:			
Depreciation and amortization	35,103	24,365	11,720
Loss on resolution of disputed revenue	—	55,345	—
Deferred compensation	446	150	191
Deferred income taxes	1,840	(23,727)	15,617
Changes in assets and liabilities which provided (used) cash:			
Accounts receivable	18,192	6,466	(127,729)
Prepaid expenses and other assets	(6,068)	(1,414)	495
Other assets	(2,294)	(2,827)	(41)
Accounts payable	2,308	1,131	(96)
Deferred revenue	3,341	1,648	873
Accrued network costs	8,575	(4,460)	8,390
Customer commissions payable	(10,193)	5,169	19,103
Other liabilities—noncurrent	1,406	4,041	274
Accrued commissions payable—related party	—	—	17,464
Accrued expenses—other	4,727	2,186	3,995
Total adjustments	57,383	68,073	(49,744)
Net cash used in operating activities	(5,971)	49,319	(25,935)
Investing Activities			
Purchase of property and equipment	(40,425)	(111,616)	(449,690)
Purchases of certificates of deposit and restricted cash	—	(127)	(6)
Net cash used in investing activities	(40,425)	(111,743)	(49,696)
Financing Activities			
Proceeds from public stock offering	6	—	114
Net proceeds from issuance of Series A Preferred Stock	—	193,760	—
Proceeds from exercise of stock options, warrants, and ESPP	1,419	1,105	—
Proceeds from long-term debt	20,000	155,000	52,000
Payments on long-term debt	—	(97,000)	—
Payment for deferred loan fees	(348)	(1,156)	(3,274)
Net cash provided by financing activities	21,077	251,709	48,840
Net (Decrease) Increase in Cash and Cash Equivalents	(25,319)	90,647	(26,791)
Cash and Cash Equivalents, Beginning of Period	105,821	15,174	41,965
Cash and Cash Equivalents, End of Period	$ 80,502	$ 105,821	$ 15,174
Supplemental Cash Flow Disclosures			
Cash Paid for Interest	$ 10,568	$ 7,377	$ 2,748
Cash Paid for Taxes	$ —	$ —	$ 2

Supplemental Noncash Investing and Financing Activities:

At December 31, 2001, 2000, and 1999, $5,452, $10,696, and $11,079, respectively, of property and equipment additions are included in outstanding accounts payable.

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2001, 2000, and, 1999
(In Thousands, Except Per Share Data)

1. Organization and Nature of Business

The consolidated financial statements include the accounts of US LEC Corp. (the "Company") and its ten wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. The Company was incorporated in 1996. On April 29, 1998, the Company completed the sale of 5,500 shares of Class A Common Stock through an initial public offering. Additionally, on May 12, 1998, the Company issued 825 shares of Class A Common Stock in connection with the underwriters' exercise of their option to cover over-allotments.

The Company, through its subsidiaries, provides switched local, long distance, data, Internet and enhanced telecommunications services primarily to businesses and other organizations in selected markets in the southeastern United States.

2. Summary of Significant Accounting Policies

Revenue Recognition—The Company recognizes revenue on telecommunications and enhanced communications services in the period that the service is provided. Revenue is recognized when earned based upon the following specific criteria: (1) persuasive evidence of arrangement exists (2) services have been rendered (3) seller's price to the buyer is fixed or determinable and (4) collectibility is reasonably assured. Reciprocal compensation that is earned as revenue from other local exchange carriers represents compensation for local telecommunications traffic terminated on our network that originates on another carrier's network. To date, a majority of our reciprocal compensation revenue has been generated from traffic originated by customers of BellSouth Telecommunications, Inc. ("BellSouth"). The billing, payment and other arrangements for this reciprocal compensation are governed by interconnection agreements between BellSouth and the Company as well as orders of the FCC and PUC's. For 2001, 2000 and 1999, revenues are recorded net of amounts that are due to a customer or outside sales agent pursuant to each respective telecommunications service contract. For the years ended December 31, 2001 and 2000 amounts incurred under these contracts of $11,890 and $7,499, respectively, are netted with gross revenues in the accompanying financial statements. Early termination fees are recognized when paid and revenue related to billings in advance of providing services is deferred and recognized when earned.

In 2000, the Company began deferring installation revenue from contracts with end customers and with other carriers. The Company is amortizing this revenue over the average life of the related contract. As of December 31, 2001 and 2000, the Company had $1,440 and $579, respectively, recorded in Deferred Revenue as a current liability on the accompanying Consolidated Balance Sheets. In addition, the Company had $2,428 and $1,463 as of December 31, 2001 and 2000, respectively, recorded in Other Liabilities for the noncurrent portion of the Deferred Revenue.

Cost of Services—In 2000, the Company began deferring installation charges from ILECs related to new customers contracts associated with Network and end customer facilities. The Company is amortizing these costs over the average life of the related contracts. During the years ended December 31, 2001 and 2000, the Company amortized $2,059 and $600, respectively, of deferred installation charges into Cost of Services. As of December 31, 2001 and 2000, the Company had $3,510 and $1,177, respectively, recorded in Other Current Assets and $2,999 and $1,749, respectively, recorded in Other Assets in the accompanying consolidated balance sheets relating to unamortized deferred installation charges.

The Company's cost of services is comprised primarily of two types of charges: leased transport charges which comprise approximately three-quarters of the Company's cost of services and usage sensitive charges (primarily usage charges associated with the Company's off net toll and toll free services and access and reciprocal compensation charges owing to other carriers) which comprise approximately one-quarter of the Company's cost of services. The Company's leased transport charges are the lease payments incurred by US LEC for the transmission facilities used to connect the Company's customers to the Company owned switch that services that customer and to connect to the ILEC and other carrier networks. US LEC, as part of its "smart-build" strategy, does not currently own any fiber or copper transport facilities. These facilities are leased from various providers including, in many cases, the ILEC. The Company's strategy of leasing rather than building its own fiber transport facilities results in the Company's cost of services being a significant component of total costs. Management believes that this strategy has several benefits, including faster time-to-market, more efficient asset utilization, and diverse interconnection opportunities. The Company has to date been successful in negotiating lease agreements which generally match in the aggregate the duration of its customer contracts, thereby allowing the Company to mitigate the risk of incurring charges associated with transmission facilities that are not being utilized by customers.

Cash and Cash Equivalents—Cash equivalents consist of highly liquid investments with original maturities of three months or less at the time of purchase.

Restricted Cash—The restricted cash balance as of December 31, 2001 and 2000 serves as collateral for letters of credit related to certain office leases.

Accounts Receivable—The $52,000 allowance against accounts receivable at December 31, 2000, was considered necessary due to a number of factors which occurred during 2000; the charge of $52,000 related to this allowance is netted on the Company's Statement of Operations, against a $12,000 reduction in commissions payable on those receivables, for which commissions were not due until the related receivables were collected, resulting in a $40,000 net charge.

At December 31, 2000, the Company reserved an additional $1.5 million of accounts receivable related to revenue sources other than reciprocal compensation In addition, the Company reclassified any remaining accounts receivable related to disputed reciprocal compensation earned prior to January 1, 2000 as non-current on the December 31, 2000 balance sheet.

Property and Equipment—Property and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, except for leasehold improvements as noted below.

The estimated useful lives of the Company's principal classes of property and equipment are as follows:

Telecommunications switching and other equipment	5-9 years
Office equipment, furniture and other	5 years
Leasehold improvements	The lesser of the estimated useful lives or the lease term

The Company capitalized $1,638 and $1,025 in payroll related costs during the years ended December 31, 2001 and 2000, respectively, in accordance with the AICPA Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use."

Long-Lived Assets—The Company reviews the carrying value of its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. Measurement of any impairment would include a comparison of estimated undiscounted future operating cash flows anticipated to be generated during the remaining life of the assets with their net carrying value. An impairment loss would be recognized as the amount by which the carrying value of the assets exceeds their fair value.

Accrued Network Costs—Accrued network costs include management's estimate of charges for direct access lines, facility charges, outgoing and incoming minutes, reciprocal compensation and other costs of revenue for a given period for which bills have not yet been received by the Company. Management's estimate is developed from the number of lines and facilities in service, minutes of use and contractual rates charged by each respective service provider. Subsequent adjustments to this estimate may result when actual costs are billed by the service provider to the Company. However, management does not believe such adjustments will be material to the Company's financial statements.

Debt Issuance Cost—The Company capitalizes loan fees associated with securing long-term debt and amortizes such deferred loan fees over the term of the debt agreement. The Company had deferred loan fees (net of accumulated amortization of $1,765 and $949) of $3,922 and $4,738 as of December 31, 2001 and 2000, respectively, recorded in other assets on the accompanying consolidated balance sheets that are being amortized over the life of the related debt agreement. (See Note 4)

Fair Value of Financial Instruments—Management believes the fair values of the Company's financial instruments, including cash equivalents, restricted cash, accounts receivables, and accounts payable approximate their carrying value. In addition, because the long-term debt consists of variable rate instruments, their carrying values approximate fair values.

Income Taxes—Income taxes are provided for temporary differences between the tax and financial accounting basis of assets and liabilities using the liability method. The tax effects of such differences, as reflected in the balance sheet, are at the enacted tax rates expected to be in effect when the differences reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized and are reversed at such time that realization is believed to be more likely than not.

Concentration of Risk—The Company is exposed to concentration of credit risk principally from trade accounts receivable due from end customers and carriers. The Company's end customers are located in the southeastern and mid-Atlantic United States. The Company performs ongoing credit evaluations of its end customers but does not require collateral deposits from a majority of its end customers. The Company is exposed to additional credit risk due to the fact that the Company's most significant trade receivables are from large telecommunications entities.

The Company is dependent upon certain suppliers for the provision of telecommunications services to its customers. The Company has executed interconnection agreements for all states in which it operates.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. Significant estimates relate to the allowance for doubtful accounts receivable, estimated end customer contract life, accrual of network costs payable to other telecommunications entities, income tax valuation allowance, and estimated useful lives of fixed assets. Any difference between the amounts recorded and amounts ultimately realized or paid will be adjusted prospectively as new facts become known.

Advertising—The Company expenses advertising costs in the period incurred. Advertising expense amounted to $1,473, $1,900 and $522, for 2001, 2000 and 1999, respectively. Advertising costs for 1999 were offset entirely by marketing incentives provided by a vendor.

Significant Customer—In 2001, 2000 and 1999 BellSouth, operating in the majority of the Company's markets, accounted for approximately 10%, 15% and 70%, respectively, of the Company's net revenue (before reduction for the $27,823, allowance in 1999). The majority of this revenue was generated from reciprocal compensation. Although reciprocal compensation owed to the Company by BellSouth is not customer revenue in the traditional sense, BellSouth is shown here due to the significant contribution to revenue. At December 31, 2001, 2000 and 1999, BellSouth accounted for 16%, 70% and 92%, of the Company's total accounts receivable before allowance, respectively. The majority of such receivables and revenues in 1999, resulted from traffic associated with Metacomm, LLC ("Metacomm"), a customer of the Company and BellSouth, which became a related party to the Company during 1998. During 2000, Metacomm ceased to be a customer of BellSouth and the Company and no revenue was recorded in 2000 related to Metacomm traffic. As a result of the March 31, 2000 order issued by the North Carolina Utilities Commission ("NCUC") denying reciprocal compensation to the Company from traffic associated with the Metacomm network, the Company recorded a pre-tax, non-recurring, non-cash charge of approximately $55,000. During 2001, the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which they resolved outstanding reciprocal compensation in the various states in which both operate and other past payments (see Note 6 to the Company's consolidated financial statements).

Recent Accounting Pronouncements—Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities by requiring that entities recognize all derivatives as either assets or liabilities at fair market value on the balance sheet. The adoption of SFAS No. 133 did not have a material effect on its results of operations as the Company does not currently hold any derivative instruments or engage in hedging activities.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS 121, "Accounting for Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed of", but retains many of its fundamental provisions, expands the scope of discontinued operations to included more disposal transactions. SFAS No. 144 will be effective for the Company for financial statements issued for the fiscal year beginning January 1, 2002. The Company has evaluated the effect the statement will have on its consolidated financial statements and related disclosures and does not believe that the effect will be material.

Reclassifications—Certain reclassifications have been made to 1999 amounts to conform to the 2001 and 2000 presentation.

3. Property and Equipment

Property and equipment at December 31, is summarized by major class as follows:

	2001	2000
Telecommunications switching and other equipment	$161,178	$145,278
Office equipment, furniture and other	72,805	56,281
Leasehold improvements	28,176	26,444
	262,159	228,003
Less accumulated depreciation and amortization	(73,723)	(39,951)
Total	$188,436	$188,052

4. Long-Term Debt

The Company's senior secured loan agreement, as amended, is comprised of (i) a $125,000 credit facility that converted into a six-year term loan as of June 30, 2001 and (ii) a $25,000 revolving credit facility that matures in December 2005. The interest rate for the facility is a floating rate based, at the Company's option, on a base rate (as defined in the loan agreement) or the London Interbank Offered Rate (LIBOR), plus a specified margin. The amount outstanding under the credit facility at December 31, 2001, was $150,000, of which $18,750 is classified as current on the Company's Consolidated Balance Sheet. Advances under the agreement as of December 31, 2001 bear interest at an annual rate ranging between approximately 6.20% and 6.43%.

The Company's credit facility is subject to certain financial covenants, measured quarterly, the most significant of which relates to the achievement of increasing levels of revenue and earnings and debt ratios. The Company was in compliance with these covenants as of the quarter ended December 31, 2001. Company management believes it will be in compliance with all quarterly financial covenants during 2002 based upon projected operating results. These projected operating results are dependent upon the Company meeting quarterly 2002 targets of new customers, customer retention, customer usage and billing rates, and as a result involve some degree of uncertainty. Should any of these assumptions not be achieved for a particular quarter, it is possible that a financial covenant will not be met during 2002. Although there can be no assurances, Company management believes if this were to occur, it would be able to obtain the necessary waivers or amendments from its lenders. The Company was successful in obtaining an amendment in the third quarter of 2001 relating to its minimum quarterly EBITDA financial covenant.

The credit facility is secured by a pledge of the capital stock of the Company's principal operating subsidiaries and a security interest in a substantial portion of the Company's and its operating subsidiaries' equipment, receivables, leasehold improvements and general intangibles. Proceeds from the credit facility have been and will be used to fund capital expenditures and working capital requirements and for other general corporate purposes. Scheduled maturities of long-term debt are as follows:

Year ending December 31:	
2002	$ 18,750
2003	18,750
2004	25,000
2005	56,250
2006	31,250
Total	$150,000

5. *Series A Mandatorily Redeemable Convertible Preferred Stock*

On April 11, 2000, the Company issued $200,000 of its Series A Mandatorily Redeemable Convertible Preferred Stock (the "Series A Preferred Stock") to affiliates of Bain Capital, Inc. (Bain) and Thomas H. Lee Partners, L.P. (THL). The Series A Preferred Stock earns dividends on a cumulative basis at an annual rate of 6%, payable quarterly in shares of Series A Preferred Stock for three years, and at US LEC's option, in cash or shares of Series A Preferred Stock over the next seven years. In addition, the Series A Preferred Stock participates on a pro rata basis in the dividends payable to common shareholders. As of December 31, 2001, the Company issued $21,568 in Series A Preferred Stock Dividends. In the event of any liquidation, dissolution or other winding up of the affairs of the Company, the holders of Series A Preferred Stock are entitled to be paid in preference to any distribution to holders of junior securities, an amount in cash, equal to $1,000 per share plus all accrued and unpaid dividends on such shares. On or after April 11, 2001, the holders of the shares of Series A Preferred Stock may convert all or a portion of their shares into shares of Class A Common Stock at a set conversion price. The initial conversion price of $35.00 has been adjusted to approximately $32.89 pursuant to the anti-dilution provisions of the Series A Preferred Stock. The holders of the Series A Preferred Stock may also convert all or a portion of their shares into Class A Common Stock at a set conversion price prior to April 11, 2010 in the event of a change in control or an acquisition event. Each holder of the Series A Preferred Stock may redeem all or a portion of their Series A Preferred Stock at a price equal to 101% of $1,000 per share plus all accrued dividends on such shares after the occurrence of a change in control and for a period of 60 days following such event. At any time on or after April 11, 2003, the Company may redeem all of the outstanding shares of Series A Preferred Stock, at a price equal to $1,000 per share plus all accrued and unpaid dividends on such shares, only if the market price of a share of common stock for 30 consecutive trading days during the 90 day period immediately preceding the date of the notice of redemption is at least 150% of the then effective conversion price and the market price of a share of common stock on the redemption date is also at least 150% of the then effective conversion price. All outstanding shares of the Series A Preferred Stock are subject to mandatory redemption on April 11, 2010. Proceeds to the Company, net of commissions and other transaction costs, were approximately $194,000.

The Company incurred $6,240 in expenses related to the issuance of the Series A Preferred Stock. The cost will be accreted against Retained Earnings (Deficit) over the life of the agreement. For the years ended December 31, 2001 and 2000, the Company accreted $491 and $336 of these costs, respectively. As of December 31, 2001 and 2000, the Company had $5,413 and $5,904 in Series A Preferred Stock issuance costs, respectively, netted with Series A Mandatorily Redeemable Convertible Preferred Stock on its Consolidated Balance Sheet.

6. Commitments And Contingencies

The deregulation of the telecommunications industry, the implementation of the Telecom Act, and the distress of many carriers in the wake of the downturn in the telecommunications industry have embroiled numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company. These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, rates applicable to different categories of traffic, and the characterization of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations, and proceedings over these and other material issues. The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of its operations.

Reciprocal Compensation—On April 27, 2001, the Federal Communications Commission ("FCC") released an Order on Remand and Report and Order (the "Remand Order") addressing inter-carrier compensation for traffic terminated to Internet service providers ("ISPs"). The interpretation and enforcement of the Remand Order will likely be the most important factor in the Company's efforts to collect reciprocal compensation for ISP-bound traffic in the future. In the Remand Order, the FCC addressed a number of important issues, including the rules under which carriers are to compensate each other for traffic terminated to ISPs and the rates applicable for ISP-bound traffic as well as traffic bound to other customers.

Importantly, while the Remand Order provides greater certainty about the Company's right to bill for traffic terminated to ISPs, the effect of the Remand Order on the Company will depend on how it is interpreted and enforced. In particular, there are uncertainties as to whether the Remand Order has any effect on the Company's pending arbitral, commission and judicial proceedings seeking to collect compensation for traffic terminated to ISPs; whether certain provisions of the Remand Order will be applied state-by-state, market-by-market and/or carrier-by-carrier; whether the limitations on growth of ISP traffic in the Remand Order will survive legal challenge; whether the Remand Order will satisfy the U.S. District Court of the District of Columbia on whose order the FCC issued the Remand Order; and whether the incumbent carrier will trigger the rate reductions and other limitations set forth in the Remand Order. If the Remand Order is interpreted in a manner adverse to the Company on all or any of the issues, or if the Remand Order is modified as a result of pending or new legal challenges, it could have a material adverse effect on the Company. For a more complete description of the Remand Order, see Busisness—Regulation.

On October 3, 2001 the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which they resolved outstanding reciprocal compensation receivables in the various states in which both operate and other past payments. BellSouth agreed to pay US LEC approximately $31,000, in addition to approximately $10,000 it paid in August 2001, to resolve those issues for periods prior to the effective date of the Remand Order. The Settlement Agreement imposed on the parties certain obligations regarding the payment of reciprocal compensation in the future, which are in the process of being implemented. The Settlement Agreement also provides that the payments made for periods prior to the effective date of the Remand Order are not subject to adjustment as a result of subsequent changes in the Remand Order.

In September 2001, the Company filed a proceeding with the Virginia State Corporation Commission ("VSCC") and the FCC seeking to collect reciprocal compensation from Verizon owing for traffic bound for ISPs as well as other customers. The VSCC declined jurisdiction over the dispute. In October 2001, the FCC accepted jurisdiction over the dispute. The Company cannot predict when the FCC will take action on this dispute or whether the Company will ultimately be successful in full; however, management believes that it will be largely successful in recovering amounts owed by Verizon in light of the Remand Order.

Disputed Access Revenues—A number of IXCs have refused to pay access charges to CLECs, including the Company, alleging that the access charges exceed the rates charged by the ILEC. Currently there are a number of court cases, regulatory proceedings at the FCC, and legislative efforts involving such challenges. The Company cannot predict the outcome of these cases, regulatory proceedings, and legislative efforts or their impact on access rates.

On April 27, 2001, the FCC released its Seventh Report and Order and Further Notice of Proposed Rulemaking (the "Access Order") in which it established a benchmark rate at which a CLEC's interstate access charges will be presumed to be reasonable and which CLECs may impose on IXCs by tariff. The Access Order addresses a number of issues important to how CLECs charge IXCs for originating and terminating interstate toll and toll free traffic.

The Access Order should provide certainty as to the Company's right to bill IXCs for interstate access at rates above those tariffed by the ILECs. Notwithstanding the apparent certainty created by the Access Order, its effect on the Company will depend on how the Access Order is interpreted and enforced and the outcome of appeals currently pending. If the Access Order is interpreted or enforced in a manner adverse to the Company as it relates to periods prior to the effective date, such result could have a material adverse effect on the Company. For a more complete description of the Access Order, please see Business—Regulation.

On May 30, 2001, the FCC issued a decision in *AT&T Corp. v. Business Telecom Inc.* (the "BTI Decision"), in which the FCC determined that the interstate access rates charged by Business Telecom, Inc. ("BTI") were not just and reasonable. The FCC determined that just and reasonable rates for BTI were properly based upon the lowest band of rates charged by the National Exchange Carriers Association ("NECA"). The FCC based this holding on the limited evidence before it, tending to show that BTI's operations were similar to those of small, urban ILECs, many of whom charge the lowest band NECA rates. BTI settled its appeal of the BTI Decision. As with the Access Order described above, the BTI Decision's effect on the Company will depend on how the order is interpreted and enforced. If the BTI Decision is interpreted or enforced in a manner adverse to the Company, such result could have a material adverse effect on the Company.

By settlement dated October 5, 2001, Sprint and the Company resolved their dispute over access charges. Sprint paid the Company approximately $8,000, in addition to approximately $1,500 it paid in the four months preceding the settlement, in payment of past due invoices for periods through July 2001.

Legislation—Periodically, legislation has been introduced in the U.S. House of Representatives or the U.S. Senate to alter or amend the Telecom Act. It is the Telecom Act which opened the local telephone markets for competition and outlines many of the ground rules pursuant to which the ILECs and the CLECs operate with respect to each other. The Company anticipates that additional efforts will be made to alter or amend the Telecom Act. The Company cannot predict whether any particular piece of legislation will become law and how the Telecom Act might be modified. The passage of legislation amending the Telecom Act could have a material adverse effect on the Company and its financial results.

Interconnection Agreements with ILECs—The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has installed a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, it will be required to negotiate extension or replacement agreements. There can be no assurance that the Company will successfully negotiate or obtain such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company.

Interconnection with Other Carriers—The Company anticipates that as its interconnections with various carriers increase, the issue of seeking compensation for the termination or origination of traffic whether by reciprocal arrangements, access charges or other charges will become increasingly complex. The Company does not anticipate that it will be cost effective to negotiate agreements with every carrier with which the Company exchanges originating and/or terminating traffic. The Company will make a case-by-case analysis of the cost effectiveness of committing resources to these interconnection agreements or otherwise billing and paying such carriers.

In October 2001, the Company entered into settlement agreements with BellSouth and Sprint resolving previously disputed accounts receivable. Included in the accompanying consolidated statement of operations for the twelve months ended December 31, 2001 is approximately $7,042 representing a net recovery of amounts previously recorded as reserves for disputed receivables and certain other accruals related to BellSouth and Sprint. Additionally, during the twelve months ended December 31, 2001, the Company recorded an additional provision for doubtful account reserves totaling approximately $13,628. This amount was recorded based upon management's assessment of the current collectibility of certain accounts receivable in consideration of the regulatory and legal environments, existing disputes, current economic conditions and the condition of certain carriers that the Company does business with. The Company believes the allowance for doubtful accounts as of December 31, 2001 is sufficient for known disputes and other impaired receivables.

Leases—The Company leases office premises in various locations under operating lease arrangements. Total rent expense on these leases amounted to $7,951, $5,734 and $4,195 in 2001, 2000 and 1999, respectively. The Company's restricted cash balance as of December 31, 2001, 2000, and 1999 serves as collateral for letters of credit for some of these office leases.

Future minimum rental payments under operating leases having initial or remaining non-cancelable lease terms in excess of one year are as follows:

2002	$ 7,708
2003	7,001
2004	6,546
2005	5,753
2006	5,163
Beyond	21,631
	$53,802

7. Income Taxes

The provision for income taxes consists of the following components:

	2001	2000	1999
Current—Charge equivalent to net tax benefit related to stock options and warrants	$ —	$ 281	$ 28
Deferred			
Federal	—	(19,545)	12,869
State	—	(4,463)	2,720
	—	(24,008)	15,589
Total provision for income taxes	$ —	$(23,727)	$15,617

The reconciliation of the statutory federal income tax rate to the Company's federal and state overall effective income tax rate is as follows:

	2001	2000	1999
Statutory federal rate	(35.00)%	(35.00)%	35.00%
State income taxes	—	(2.06)	4.49
Change in valuation allowance	33.59	20.05	—
Miscellaneous	1.41	.20	.11
Effective tax rate	0%	(16.81)%	39.60%

Deferred income taxes reflect the net tax effects of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2001, 2000 and 1999 are as follows:

	2001	2000	1999
Deferred tax assets:			
Net operating loss carryforward	$ 82,322	$ 57,568	$17,054
Deferred state taxes and other	120	—	1,696
Accrued expenses	5,908	1,293	727
Deferred tax assets	88,350	58,861	19,477
Less: Valuation Allowance	(61,045)	(35,669)	—
Total deferred tax assets	27,305	23,192	19,477
Deferred tax liabilities:			
Net deferred revenues	—	3,747	33,476
Depreciation and amortization	26,083	18,937	9,811
Other	1,222	508	146
Total deferred tax liabilities	27,305	23,192	43,433
Net Deferred Tax Liability	$ 0	$ 0	$23,956

For the years ended December 31, 2001 and 2000, a valuation allowance has been provided against the net deferred tax assets since management cannot predict, based on the weight of available evidence, that it is more likely than not that such assets will be ultimately realized.

At December 31, 2001, the Company has net operating loss carryforwards for federal and state tax purposes of approximately $195,000. Such losses begin to expire for federal and state purposes in 2017 and 2012, respectively.

8. Related Parties

During 1998, the Company's majority stockholder acquired an indirect controlling interest in Metacomm. Metacomm was engaged in the business of developing and operating a high-speed data network in North Carolina, and was a customer of the Company and BellSouth during 1999 and 1998. The Company recorded $9,511 in revenue earned from services provided to Metacomm (which did not include revenue from reciprocal compensation due from BellSouth, see Note 6) during 1999. Metacomm also earned commissions from the Company for reciprocal compensation revenue relating to Metacomm's network. The Company recorded $38,990 for 1999 in reciprocal compensation commission expense earned by Metacomm, which is included in cost of services in the accompanying financial statements. The Company and Metacomm were parties to agreements by which commissions earned by Metacomm related to reciprocal compensation would not be paid to Metacomm until the related reciprocal compensation is collected from the ILEC. However, in 1999 the Company advanced to Metacomm $12,015 prior to collecting the earned reciprocal compensation from BellSouth. On March 31, 2000 the NCUC issued an order that relieved BellSouth from paying reciprocal compensation to the Company for any minutes of use attributable to Metacomm. The Company recorded no revenue associated with the Metacomm network in 2001 or 2000. As a result of the order, the Company subsequently recorded a pre-tax, non-recurring, non-cash charge of approximately $55,000 in the first quarter of 2000. The charge was composed of the write-off of approximately $153,000 in receivables related to reciprocal compensation revenue offset by previously established reserves of $39,000 and a reduction of $59,000 in commissions payable to Metacomm.

The Company incurred $50 in 1999 in expenses for consulting services provided by Global Vista Communications, LLC ("Global Vista"). As of December 31 1999, a liability totaling $66 was included in accounts payable in the Company's financial statements, relating to software and consulting services purchased from Global Vista. In addition, during 1999 and 2000, the Company acquired $2,081 and $2, respectively, in software from Global Vista Communications, LLC ("Global Vista"), a company controlled by the Company's majority stockholder.

During 2000 and 1999, the Company capitalized $858 and $185 , respectively in site acquisition costs for services performed by Lincoln Harris LLC, a company controlled by a former member of the Company's Board of Directors. These costs are included in leasehold improvements in the accompanying financial statements. In addition, the Company incurred $159, $95 and $3 in 2001, 2000 and 1999, respectively, in expenses for services provided by Lincoln Harris. As of December 31, 2001, 2000 and 1999, a liability totaling $0, $27 and $46, respectively, was recorded in accounts payable in the Company's financial statements relating to leasehold improvements and services purchased from Lincoln Harris LLC.

During 1999, the Company entered into an operating lease with H-C REIT, Inc., a Company controlled by a former member of the Company's Board of Directors. The lease commenced on May 1, 2000, and continues for a period of ten years. As part of the new lease agreement, H-C REIT, Inc. agreed to limit the Company's liability under their existing lease agreement to $500 for early termination and lease incentive costs. The Company recognized this expense in 1999. During 2001 and 2000, the Company paid H-C REIT, Inc. $1,922 and $1,706, respectively, under this lease agreement.

Company management believes that all of the above transactions were on terms no less favorable to the Company than could have been arranged with unrelated parties.

9. Employee Benefit Plan

The Company has a 401(k) savings plan under which employees can contribute up to 15% of their annual salary. For 2001, 2000, and 1999, respectively, the Company made matching contributions to the plan totaling $1,006, $768 and $381 based on 50% of the first 6% of an employee's contribution to the plan.

10. Stockholders' Equity

Common Stock—Prior to the completion of the recapitalization transaction described below, the Company had previously authorized and issued two classes of common stock, Class A and Class B. As a result of the aforementioned recapitalization, 2,000 shares of Class B Common stock were cancelled and the remaining 14,000 shares of Class B were converted into the same number of Class A Common Shares. The rights of holders of the Class A Common Stock are entitled to one vote per share in the election of the members of the Board of Directors.

Employee Stock Purchase Plan—In May 2000, the Company's shareholders approved and the Company adopted the Employee Stock Purchase Plan (the "Stock Purchase Plan"). Under the terms of the Stock Purchase Plan, as of September 1, 2000 ("the effective date"), the Board of Directors reserved 1,000 shares of common stock for the plan. The Stock Purchase Plan provides for specified offering periods (initially the period from the effective date to December 31, 2000 and thereafter, the six month periods between January and June and July and December of each respective year) during which an eligible employee is permitted to accumulate payroll deductions in a plan account for the purchase of shares of Class A Common Stock. Substantially all employees may elect to participate in the Stock Purchase Plan by authorizing payroll deductions in an amount not exceeding ten percent (10%) of their compensation payable during the offering period, and not more than $25 annually. The purchase price per share will be the lower of 85% of the market value of a share as of the first day of each offering period or 85% of the market value of a share as of the last day of each offering period. The Company is presently authorized to issue 2,000 shares of common stock under the Stock Purchase Plan. As of December 31, 2001, there were 437 employees participating in the Stock Purchase Plan. The Company issued share amounts of 323, 295, and 108 shares at a purchase price of $2.30, $2.30 and $4.09 per share, respectively, which represents a 15% discount to the closing price on December 31, 2001, June 30, 2001 and December 29, 2000, respectively.

Stock Option Plan—In January 1998, the Company adopted the US LEC Corp. 1998 Omnibus Stock Plan (the "Plan"). In August 1998, the Company filed a registration statement to register (i) 1,300 shares of Class A Common Stock reserved for issuance under the Stock Plan and (ii) 180 shares of Class A Common Stock reserved for issuance upon the exercise of nontransferable warrants granted by the Company to employees. In April 1999, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 1,300 shares to 2,000 shares and in May 1999, the Company filed a registration statement to register these additional 700 shares. In May 2000, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 2,000 shares to 3,500 shares and in August 2000, the Company filed a registration statement to register these additional 1,500 shares. In May 2001, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 3,500 shares to 5,000 shares and in 2001, the Company filed a registration statement to register these additional 1,500 shares. Under the amended Stock Plan, 5,000 shares of Class A Common Stock have been reserved for issuance for stock options, stock appreciation rights, restricted stock, performance awards or other stock-based awards. Options granted under the Stock Plan are at exercise prices determined by the Board of Directors or its Compensation Committee. For incentive stock options, the option price may not be less than the market value of the Class A Common Stock on the date of grant (110% of market value for greater than 10% stockholders).

In January 1998, the Company granted incentive stock options to substantially all employees to purchase an aggregate of 183 shares of Class A Common Stock at $10 per share (fair market value on date of grant was $13 per share). These options began vesting annually in four equal installments beginning in January 1999. The Company recorded deferred compensation of $548 in 1998 associated with these options which will be amortized to compensation expense over the four-year vesting period. The Company amortized $73, $60, and $101 for 2001, 2000, and 1999, respectively, to compensation expense relating to these options, after consideration of forfeitures.

Also, during 1998, the Company granted to an employee an option to purchase 360 shares of Class A Common Stock at $13 per share (fair market value on the date of grant was $14 per share). The Company recorded deferred compensation of $360 associated with these options and will amortize this amount to compensation expense over the four year vesting period. The Company amortized $90 for 2001, 2000, and 1999, respectively, to compensation expense relating to these options. In both 1998 and 1999 the Company granted options to purchase 5 shares of Class A Common Stock at the fair market value on the date of grant to each of the Company's two and three outside directors, respectively. These options vested immediately upon grant.

In December 2001, the Company granted to an employee an option to purchase 550 shares of Class A Common Stock at $2.91 per share (fair market value on the date of grant was $5.60 per share). The Company recorded deferred compensation of $1,480 associated with these options. The Company will amortize compensation expense over a three year vesting period for 450 of these options. The remaining 100 shares vested immediately. The Company amortized $283 for 2001 to compensation expense relating to these vested options.

A summary of the option and warrant activity is as follows:

	Options			Warrants		
	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Fair Value at Date of Grant	Number of Warrants	Weighted Average Exercise Price Per Warrant	Weighted Average Fair Value at Date of Grant
Balance at December 31, 1998	1,082	$ 8.00		304	$ 3.45	
Granted at fair market value	794	$22.65	$10.29	—	—	
Exercised	(14)	7.85		(5)	2.86	
Forfeited or cancelled	(67)	12.66		—	—	
Balance at December 31, 1999	1,795	$14.30		299	$ 3.46	
Granted at fair market value	1,226	$12.58	$ 8.51	—	—	
Exercised	(29)	10.84		(131)	2.86	
Forfeited or cancelled	(344)	19.12		—	—	
Balance at December 31, 2000	2,648	$12.92		168	$ 3.92	
Granted at fair market value	1,651	$ 4.41	$ 2.96	—	—	
Granted at less than fair market value	550	2.91	4.41	—	—	
Exercised 0	(2)	3.50		—	—	
Forfeited or cancelled	(346)	12.12		(25)	10.00	
Balance at December 31, 2001	4,501	$ 8.64		143	$ 2.86	

* Includes 744 options repriced

A summary of the range of exercise prices and weighted average remaining lives for options and warrants outstanding and exercisable at December 31, 2001 is as follows:

	Options Outstanding					
	Range of Exercise Price	Number of Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
Options granted at fair market value . . .	$ 2.73 – $3.41	560	9.5 years	$ 3.36	—	—
	3.50 – 4.11	479	9.2 years	3.98	24	$ 3.50
	4.50 – 5.81	567	9.6 years	5.38	—	—
	6.06 – 6.88	382	8.8 years	6.12	94	6.06
	— – 7.31	797	6.7 years	7.31	596	7.31
	7.69 – 16.50	443	7.9 years	12.65	202	12.74
	18.00 – 25.50	355	8.2 years	19.11	112	19.48
	25.75 – 37.13	364	8.0 years	27.04	167	26.65
	3.50 – 37.13	3,947	8.4 years	9.43	1,195	11.90
Options granted at less than fair market value	2.91 – 10.00	554	10.0 years	2.96	103	3.12
Total options outstanding at December 31, 2001	$ 2.73 –$37.13	4,501	8.6 years	$ 8.64	1,298	$11.20

	Warrants Outstanding			
	Range of Exercise Price	Number of Warrants Outstanding and Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
Warrants granted at fair market value	$2.86	143	3 years	$2.86
Total options warrants at December 31, 2001	$2.86	143	3 years	$2.86

The Company measures the compensation cost of its stock option plan under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees", as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation". Under the provisions of APB No. 25, compensation cost is measured based on the intrinsic value of the equity instrument awarded. Under the provisions of SFAS No. 123, compensation cost is measured based on the fair value of the equity instrument awarded.

Had compensation cost for the employee warrants and stock options been determined consistent with SFAS No. 123, the Company's net earnings (loss) and net earnings (loss) per share would approximate the following proforma amounts:

	1999		2000		2001	
	As Reported	Proforma	As Reported	Proforma	As Reported	Proforma
Net earnings (loss)	$23,809	$22,463	$(117,392)	$(121,436)	$(63,354)	(70,454)
Preferred dividends	—	—	(8,758)	(8,758)	(12,810)	(12,810)
Accretion of preferred Stock issuance fees	—	—	(336)	(336)	(491)	(491)
Net earnings (loss) attributable to shareholders	$23,809	$22,463	$(126,486)	$(130,530)	$(76,655)	(83,755)
Earnings (loss) per share:						
Basic	0.87	0.82	(4.58)	(4.73)	(2.83)	(3.09)
Diluted	0.84	0.79	(4.58)	(4.73)	(2.83)	(3.09)

The Company estimated the fair value for both the stock options and the warrants using the Black-Scholes model assuming no dividend yield in 2001, 2000 and 1999; volatility of 80%, 80%, and 40%, for 2001, 2000, and 1999, respectively, an average risk-free interest rate of 6.0%, 6.5%, and 6.5% for 2001, 2000, and 1999, respectively, an expected life of 12 months for the warrants and 4.9, 5.0 and 5.1 years for the stock options in 2001, 2000, and 1999 respectively. The weighted average remaining contractual life of warrants and stock options outstanding at December 31, 2001 was 3.0 years and 8.6 years, respectively.

The Company estimated the fair value of the Employee Stock Purchase Plan shares based upon the stock price at December 31, 2001 (the "issue date"). Compensation cost was estimated based upon the intrinsic value of the award at the issue date.

In 2000, additional paid-in-capital was reduced by approximately $36,000 representing amounts due from Metacomm, which is indirectly controlled by Richard T. Aab, the Company's Chairman and largest stockholder. Due to Mr. Aab's controlling position in both Metacomm and the Company, this amount was treated for financial reporting purposes as a deemed distribution to the stockholder.

On March 31, 2001, the Company, Richard T. Aab, the Company's Chairman, controlling shareholder at that time and the indirect controlling owner of Metacomm, and Tansukh V. Ganatra, the Company's former Vice Chairman and Chief Executive Officer, reached an agreement in principle to effect a recapitalization of the Company and to resolve Mr. Aab's commitment that Metacomm would fully satisfy its obligations to the Company for facilities, advances and interest. This transaction was closed on August 6, 2001. Under the agreement, the following events occurred: (1) Mr. Aab made a contribution to the capital of the Company by delivering to the Company for cancellation 2,000 shares of Class B Common Stock, (2) Mr. Aab and Mr. Ganatra converted all of the then remaining and outstanding shares of Class B Common Stock—a total of approximately 14,000 such shares were outstanding after the 2,000 shares were cancelled—into the same number of shares of Class A Common Stock. As set out in the articles of incorporation, Class B Shares that have been converted to Class A can not be reissued (3) the Company agreed to indemnify Mr. Aab for certain adverse tax effects, if any, relating to the Company's treatment in its balance sheet of the amount of the Metacomm obligation as a distribution to shareholder and (4) the Company agreed to indemnify Mr. Ganatra for certain adverse tax effects, if any, from the conversion of his Class B shares to Class A shares.

As required by the agreement, the Company obtained a valuation by a qualified valuation firm approved by the Company's audit committee that the delivery of the 2,000 shares of Class B Common Stock and the conversion of the approximately 14,000 shares of Class B Common Stock into the same number of shares of Class A Common Stock would result in the realization by the Company and its Class A shareholders of value approximately equal to the outstanding Metacomm obligation, received a favorable tax opinion, and received certain consents.

As a result of this transaction, the number of issued and outstanding shares of Common Stock (Class A and Class B together) decreased by 2,000 and, as a result of the elimination of the 10-vote-per-share Class B Common Stock, Mr. Aab no longer holds shares representing a majority of the voting power of the Company's outstanding Common Stock, although he remains its largest single shareholder.

11. Earnings (Loss) Per Share

Earnings (loss) per common and common equivalent share are based on net income (loss), after consideration of preferred stock dividends, and accretion divided by the weighted average number of common shares outstanding during the period. Outstanding options and warrants are included in the calculation of dilutive earnings per common share to the extent they are dilutive. Following is the reconciliation of earnings (loss) per share for, 2001, 2000 and 1999:

	2001	2000	1999
Basic earnings (loss) per share:			
Net earnings (loss)	$(63,354)	$(117,392)	$23,809
Preferred dividends	(12,810)	(8,758)	—
Accretion of preferred stock Issuance fees	(491)	(336)	—
Net earnings(loss)applicable to Common shareholders	$(76,655)	$(126,486)	$23,809
Weighted average shares outstanding	27,108	27,618	27,431
Basic earnings (loss) per share	$ (2.83)	$ (4.58)	$ 0.87
Diluted earnings (loss) per share:			
Net earnings (loss)	$(63,354)	$(117,392)	$23,809
Preferred dividends	(12,810)	(8,758)	—
Accretion of preferred stock Issuance fees	(491)	(336)	—
Net earnings (loss) applicable to Common shareholders	$(76,655)	$(126,486)	$23,809
Weighted average shares outstanding	27,108	27,618	27,431
Dilutive effect of stock options	—	—	725
Dilutive effect of warrants	—	—	255
Weighted average shares, adjusted	27,108	27,618	28,411
Diluted earnings (loss) per share	$ (2.83)	$ (4.58)	0.84

12. Quarterly Financial Data (Unaudited)

The following table summarizes the Company's results of operations as presented in the consolidated statements of operations by quarter for 2001, 2000, and 1999.

	Quarter Ended			
	March 31, 2001	June 30, 2001	Sept. 30, 2001	Dec. 31, 2001
Revenue, Net	$ 38,055	$ 43,051	$ 45,982	$ 51,513
Cost of Services	19,171	21,911	23,276	25,939
Gross Margin	18,884	21,140	22,706	25,574
Selling, General and Administrative	24,228	26,017	38,087	26,565
Recovery for Disputed Receivables (Note 6)	—	—	(7,042)	—
Depreciation and Amortization	7,775	7,992	8,752	10,584
Loss from Operations	(13,119)	(12,869)	(17,091)	(11,575)
Interest Income (Expense), Net	(1,980)	(2,189)	(2,331)	(2,200)
Loss Before Income Taxes	(15,099)	(15,058)	(19,422)	(13,775)
Provision for Income Taxes	—	—	—	—
Net Loss	(15,099)	(15,058)	(19,422)	(13,775)
Preferred Stock Dividends	3,131	3,178	3,226	3,274
Accretion of Preferred Stock Issuance Cost	120	122	124	125
Net Loss Available to Common Shareholders	$(18,350)	$(18,358)	$(22,772)	$(17,174)
Net Loss per Share:				
Basic	$ (.66)	$ (.66)	$ (.85)	$ (.66)
Diluted	$ (.66)	$ (.66)	$ (.85)	$ (.66)
Weighted Average Shares Outstanding:				
Basic	27,768	27,771	26,846	26,067
Diluted	27,768	27,771	26,846	26,067

US LEC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Quarter Ended			
	March 31, 2000	June 30, 2000	Sept. 30, 2000	Dec. 31, 2000
Revenue, Net	$ 25,363	$ 26,148	$ 29,860	$ 33,593
Cost of Services	11,051	11,714	14,359	15,560
Gross Margin	14,312	14,434	15,501	18,033
Selling, General and Administrative	16,013	18,764	22,049	23,858
Loss on Resolution of Disputed Revenue (Note 2)	55,345	—	—	—
Provision for Disputed Receivables (Note 2 and 6)	—	—	—	40,000
Depreciation and Amortization	4,393	5,674	6,201	8,097
Loss from Operations	(61,439)	(10,004)	(12,749)	(53,922)
Interest Income (Expense), Net	(1,890)	324	(278)	(1,161)
Loss Before Income Taxes	(63,329)	(9,680)	(13,027)	(55,083)
Provision for Income Taxes	(23,727)	—	—	—
Net Loss	(39,602)	(9,680)	(13,027)	(55,083)
Preferred Stock Dividends	—	2,633	3,040	3,085
Accretion of Preferred Stock Issuance Cost	—	—	—	336
Net Loss Available to Common Shareholders	$(39,602)	$(12,313)	$(16,067)	$(58,504)
Net Loss per Share:				
Basic	$ (1.44)	$ (.45)	$ (.58)	$ (2.12)
Basic	$ (1.44)	$ (.45)	$ (.58)	$ (2.12)
Weighted Average Shares Outstanding:				
Basic	27,513	27,636	27,660	27,661
Diluted	27,513	27,636	27,660	27,661

	Quarter Ended			
	March 31, 1999	June 30, 1999	Sept. 30, 1999	Dec. 31, 1999
Revenue, Net	$36,212	$43,553	$47,348	$48,067
Cost of Services	15,762	18,702	19,524	19,625
Gross Margin	20,450	24,851	27,824	28,442
Selling, General and Administrative	9,666	11,806	13,707	13,196
Depreciation and Amortization	2,320	2,676	3,124	3,600
Earnings from Operations	8,464	10,369	10,993	11,646
Interest Income (Expense), Net	(35)	(359)	(621)	(1,031)
Earnings Before Income Taxes	8,429	10,010	10,372	10,615
Provision for Income Taxes	3,414	4,035	4,170	3,998
Net Earnings	$ 5,015	$ 5,975	$ 6,202	$ 6,617
Net Earnings per Share:				
Basic	$ .18	$ .22	$ .23	$ .24
Diluted	$ .18	$ .21	$ .22	$ .23
Weighted Average Shares Outstanding:				
Basic	27,422	27,427	27,428	27,447
Diluted	28,206	28,381	28,520	28,554

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

(1) The information required in response to Item 10 related to directors is incorporated by reference from the sections of the Proxy Statement that appear under the heading "Election of Directors". The information required in response to Item 10 related to Executive Officers is provided in Part I of this report under the heading "Executive Officers of the Registrant".

ITEM 11. EXECUTIVE COMPENSATION

The information required to be furnished in response to Item 11 is incorporated by reference from the sections of the Proxy Statement that appear under the headings "Compensation of Directors" and "Compensation of Executive Officers".

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required to be furnished in response to Item 12 is incorporated by reference from the section of the Proxy Statement that appear under the heading "Security Ownership of Certain Beneficial Owners and Management".

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required to be furnished in response to Item 13 is incorporated by reference from the section of the Proxy Statement that appear under the heading "Certain Relationships and Related Transactions".

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULE AND REPORTS ON FORM 8-K

(a) Financial Statements, Financial Statement Schedule and Exhibits—The following documents are filed as part of this Form 10-K.

(1) Financial statements:

A. Consolidated Balance Sheets as of December 31, 2001 and 2000

B. Consolidated Statements of Operations years ended December 31, 2001, 2000, and 1999

C. Consolidated Statements of Stockholders' Equity (Deficiency) years ended December 31, 2001, 2000 and 1999

D. Consolidated Statements of Cash Flows for the years ended December 31, 2001, 2000, and 1999

E. Notes to Consolidated Financial Statements for the years ended December 31, 2001, 2000, and 1999

F. Independent Auditors' Report

(2) Schedule II Valuation and Qualifying Accounts

(3) List of Exhibits:

No.	Exhibit
3.1	Restated Certificate of Incorporation of the Company (1)
3.2	Restated Bylaws of the Company (2)
3.3	Certificate of Designation Relating to Series A Convertible Preferred Stock (3)
3.4	Amendment to Certificate of Designation Related to Series A Convertible Preferred Stock
4.1	Form of Class A Common Stock Certificate (1)
4.2	Preferred Stock Purchase Agreement, dated April 11, 2000 (3)
4.4	Corporate Governance Agreement, dated April 11, 2000 (3)
4.5	Registration Rights Agreement, dated April 11, 2000 (3)
4.6	Voting and Tag Along Agreement dated as of April 11, 2000 by and among certain Investors, Richard T. Aab, Melrich Associates, L.P., Tansukh V. Ganatra and Super STAR Associates Limited Partnership
4.7	Amendment to Voting and Tag Along Agreement dated as of August 6, 2001 by and among Richard T. Aab, Melrich Associates, L.P., Super STAR Associates Limited Partnership, Bain Capital CLEC Investors, L.L.C., Thomas H. Lee Equity Fund IV, L.P., Thomas H. Lee Foreign Fund IV-B, L.P. and Thomas H. Lee Foreign Fund IV, L.P.
10.2	Second Amended Loan and Security Agreement, dated as of December 20, 1999, among US LEC Corp., certain operating subsidiaries of US LEC Corp., General Electric Capital Corporation, First Union National Bank and Wachovia Bank N.A. (the "Loan and Security Agreement") (4)
10.3	Amendment dated November 10, 2000 to Loan and Security Agreement (2)
10.4	Plan of Recapitalization dated August 6, 2001 by among the Company, Metacomm, LLC, Richard T. Aab, Melrich Associates, L.P., Tansukh V. Ganatra and Super STAR Associates Limited Partnership
10.5	Indemnity Agreement dated as of August 6, 2001 by and among the Company, Metacomm, LLC, RTA Associates, LLC, Richard T. Aab and Joyce M. Aab

10.6	Indemnity Agreement dated as of August 6, 2001 by and among the Company, Tansukh V. Ganatra, Sarlaben T. Ganatra, Rajesh T. Ganatra and Super STAR Associates Limited Partnership
10.7	Employment Agreement dated as of December 18, 2001 by and between the Company and Francis J. Jules (5)
10.8	Consulting Agreement dated as of February 7, 2002 by and between the Company and Tansukh V. Ganatra (5)
21	Subsidiaries of the Registrant
23	Consent of Deloitte & Touche LLP

(1) Incorporated by reference to Registration Statement from Form S-1 (File No. 333-46341) filed February 13, 1998.

(2) Incorporated by reference to the Company's Annual Report on Form 10-K for its year ended December 31, 2000.

(b) Reports on Form 8-K.

(3) Incorporated by reference to the Company's Current Report on Form 8-K filed May 12, 2000.

(4) Incorporated by reference to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1999.

(5) Management or compensatory plan or arrangement.

No Current Reports on Form 8-K were filed during the fiscal quarter ended December 31, 2001.

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

US LEC CORP. (In Thousands)

Description	Balance at Beginning of Period (Dec. 31, 2000)	Additions		Deductions	Balance at End of Period (Dec. 31, 2001)
		Charged to Costs and Expenses	Charged to Other Accounts		
Allowance against accounts receivables	$53,523	$ 6,586*	$3,318	$51,164	$12,263
Allowance against deferred tax assets	$35,669	$25,376	$ 0	$ 0	$61,045

* Represents the provision for doubtful account reserves recorded during the year ended December 31, 2001 of $13,628 included in selling, general and administrative expenses in the accompanying consolidated statements of operations, net of the recovery of amounts previously reserved for disputed receivables of $7,042.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 29, 2002

By: /s/ RICHARD T. AAB
Richard T. Aab
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ RICHARD T. AAB **Richard T. Aab**	Chairman and Director	March 29, 2002
/s/ FRANK J. JULES **Frank J. Jules**	Chief Executive Officer and Director (Principal Executive Officer)	March, 29, 2002
/s/ MICHAEL K. ROBINSON **Michael K. Robinson**	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 29, 2002
/s/ TANSUKH V. GANATRA **Tansukh V. Ganatra**	Director	March 29, 2002
/s/ DAVID M. FLAUM **David M. Flaum**	Director	March 29, 2002
/s/ STEVEN L. SCHOONOVER **Steven L. Schoonover**	Director	March 29, 2002
/s/ ANTHONY J. DINOVI **Anthony J. Dinovi**	Director	March 29, 2002
/s/ MICHAEL A. KRUPKA **Michael A. Krupka**	Director	March 29, 2002

EXHIBIT 21

SUBSIDIARIES OF REGISTRANT

US LEC of North Carolina Inc. (North Carolina Corporation)

US LEC of Georgia Inc. (Delaware Corporation)

US LEC of Tennessee Inc. (Delaware Corporation)

US LEC of Florida Inc. (North Carolina Corporation)

US LEC of South Carolina Inc. (Delaware Corporation)

US LEC of Alabama Inc. (North Carolina Corporation)

US LEC of Maryland Inc. (North Carolina Corporation)

US LEC of Pennsylvania Inc. (North Carolina Corporation)

US LEC Communications Inc. (North Carolina Corporation)

US LEC of Virginia L.L.C. (Delaware Limited Liability Company)

EXHIBIT 23

INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statement Nos. 333-78075, 333-61617, 333-42890 and 333-42976 of US LEC Corp. and subsidiaries on Form S-8 of our report dated February 21, 2002, appearing in the Annual Report on Form 10-K of US LEC Corp. and subsidiaries for the year ended December 31, 2001.

/s/ DELOITTE & TOUCHE LLP

Charlotte, North Carolina
March 29, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K
ANNUAL REPORT
PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
FOR THE YEAR ENDED DECEMBER 31, 2002

Commission File Number: 0-24061

US LEC CORP.
(Exact name of registrant as specified in its charter)

DELAWARE	**56-2065535**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

Morrocroft III, 6801 Morrison Boulevard
CHARLOTTE, NORTH CAROLINA 28211
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (704) 319-1000

Securities registered pursuant to Section 12(b) of Act: None.

Securities registered pursuant to Section 12(g) of Act: Class A Common Stock, par value $.01 per share.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is an accelerated filer as defined in Exchange Rule 12b-2. Yes ☐ No ☒

The aggregate market value of voting stock of the registrant held by non-affiliates of the registrant was $28,985,427 as of June 30, 2002 based on the closing sales price on The Nasdaq SmallCap Market as of that date. For purposes of this calculation only, affiliates are deemed to be directors and executive officers of the registrant.

As of March 24, 2003 there were 26,894,839 shares of Class A common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for its Annual Meeting of Stockholders to be held on May 22, 2003 are incorporated by reference into Part III of this report.

US LEC CORP.
2002 ANNUAL REPORT ON FORM 10-K
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PART I

ITEM 1. BUSINESS

THE COMPANY

US LEC Corp. ("US LEC" or the "Company) is a Charlotte, NC-based telecommunications carrier providing voice, data and Internet services to over 10,000 mid-to-large-sized business customers throughout the southeastern and mid-Atlantic United States. As of December 31, 2002, the US LEC network consisted of 26 Lucent 5ESS® AnyMedia™ digital switches, 26 Lucent CBX500 Asynchronous Transfer Mode ("ATM") data switches, five Juniper Networks® M20™ Internet Gateway routers and an Alcatel MegaHub® 600ES tandem switch. The US LEC local service area includes Alabama, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, New Jersey, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia and the District of Columbia. US LEC also offers selected voice services in Arkansas, California, Connecticut, Indiana, Massachusetts, Montana, Nevada, New York, Ohio, Texas and Wisconsin, in addition to providing data services in these and other states. The Company primarily serves telecommunications-intensive business customers including the automotive, construction, education, financial, government, healthcare, hospitality, Internet service providers, other telecommunication carriers, professional/legal, real estate, retail and transportation sectors.

US LEC was founded in 1996 and first initiated service in North Carolina in March 1997, becoming one of the first competitive local exchange carriers ("CLEC") in North Carolina to provide switched local exchange services.

BUSINESS STRATEGY

US LEC's objective is to be the premier communications partner for businesses by delivering quality voice and data services and exceeding expectations for customer care.

The principal elements of US LEC's business strategy include:

Offer a Broad Range of Products and Services. US LEC offers customers a broad range of telecommunication services which can be bundled on a single customer network connection. Management believes a broad product range, competitive pricing and an opportunity to bundle services gives US LEC customers an exceptional value. US LEC offers its customers local access, calling card, audio conferencing, digital private line, frame relay, ATM, dedicated high-speed Internet access, Web hosting, email, dial-up Internet access, managed firewall and Internet Protocol-Virtual Private Network ("IP-VPN"), as well as long distance services that include intrastate, interstate, international and toll-free calling. To further the Company's product strategy, US LEC has deployed its IP, ATM and Advanced Intelligent Network ("AIN") platforms. These systems provide the Company the ability to provide advanced voice and data communications products and services.

Target Telecommunications-Intensive Customers. The Company focuses its sales efforts on telecommunications-intensive business customers that include the automotive, construction, education, financial, government, healthcare, hospitality, Internet service providers, professional/legal, real estate, retail, transportation sectors and telecommunication providers. By focusing on such customers, the Company is able to more efficiently concentrate their telecommunications traffic. In addition, the Company frequently is able to bundle its local, long distance, data and Internet services. This further enhances network utilization and thereby improves margins, as fixed network costs are spread over a larger base of services. Unlike some other CLECs, the Company does not resell incumbent local exchange carrier ("ILEC") dial tone services.

Provide Outstanding Customer Service. Management believes that a key element of the success of a CLEC is the ability to satisfy the service needs of its customers. The Company must be able to resolve customer issues, promptly implement change requests, resolve billing issues and promptly add additional service and capacity. Management believes that providing customers with outstanding customer care enhances the ability of the Company to retain its customers, as well as attract new customers. Customer care is provided locally by the market-based sales, sales support and operations team and centrally by US LEC's network operations center ("NOC") and customer service center.

Deploy a Capital-Efficient Network. US LEC utilizes a "smart-build" strategy of owning and deploying switching and routing equipment and leasing the required fiber optic transmission capacity from competitive access providers ("CAPs"), CLECs, interexchange carriers ("IXCs") or ILECs. Management believes the Company's switch-based, leased-transport strategy enables it to enter and penetrate markets, and generate revenue and positive cash flow more rapidly than if the Company first constructed its own transmission facilities. By leasing fiber transport, this Smart-Build strategy also reduces the up-front capital expenditures required to build a network and enter new markets and avoids the risk of "stranded" investment in under-utilized fiber networks.

Install a Robust Technology Platform. The Company has chosen the 5ESS® Any Media™ digital switch and the CBX500 ATM data switches, both of which are manufactured by Lucent Technologies, Inc. ("Lucent") to provide a consistent technology platform throughout its network. As of December 31, 2002, US LEC had 26 Lucent voice switches and 26 Lucent ATM data switches active throughout its network. To enhance its service offerings, the Company deployed an Alcatel MegaHub 600ES ("Alcatel") tandem switch in Charlotte, NC. In addition, the Company has also deployed five Juniper Networks® M20™ Internet Gateway routers to provide reliable, scalable, and high-speed network elements to significantly enhance the performance of US LEC's Internet access service.

Focus of Operations. The Company focuses its network and marketing presence in target markets composed of Tier I cities (major metropolitan areas such as Atlanta, Miami, Philadelphia and Washington D.C.) and Tier II cities (mid-size metropolitan areas such as Greensboro, Nashville and Tampa). The Company has selected target markets based on a number of considerations, including the number of potential customers and competitors in such markets and the presence of multiple transmission facility suppliers. The Company currently focuses on markets in the southeast and mid-Atlantic United States. Management believes that the Company's strategically designed network will enable it to take advantage of customer relationships, calling patterns and capture an increasing portion of customer traffic on its network.

Employ an Experienced Sales Force. Management believes that employing a direct sales force with extensive local market and telecommunications sales experience enhances the Company's success in a particular market. The Company employs this strategy in building its sales force. Salespeople with experience in a particular market provide the Company with extensive knowledge of the Company's target customer base and in many cases have existing relationships with target customers.

Implement Efficient Provisioning Processes with State-of-the-Art Back Office Support. Management believes that a critical aspect of the success of a CLEC is timely and effective provisioning systems, which includes the process of transitioning new ILEC, IXC or other CLEC customers to the Company's network. The Company focuses on implementing effective and timely provisioning practices to efficiently transition customers from the ILEC, IXC or other CLECs to the Company with minimal disruption of the customer's operations. US LEC is approved by NeuStar, Inc. as a provider of Local Number Portability ("LNP") for its customers. In addition, the US LEC NOC houses the tools to monitor its network. The NOC provides network surveillance, real-time alarm notification, dispatch services, and availability and notification 24 hours a day, 7 days a week.

US LEC'S NETWORK

The US LEC network consists of 26 Lucent 5ESS® AnyMedia™ digital switches, 26 Lucent CBX500 ATM data switches, five Juniper Networks® M20™ Internet Gateway routers and an Alcatel MegaHub® 600ES tandem switch.

Data transmissions from a US LEC customer are transported over leased lines to the US LEC switch and can then be transmitted directly on the Company's network or transmitted to another carrier for termination. Data transmissions to a US LEC customer work in reverse. Internet access for US LEC customers is provided by transport over leased lines to the US LEC switch, transmitted over leased lines to one of US LEC's Internet Gateways if necessary, and then to the Internet via Internet transit leased from other carriers.

Voice calls originating with a US LEC customer are transported over leased lines to the US LEC switch and can either be terminated directly on the Company's network or routed to a long distance carrier, an ILEC or another CLEC, depending on the location of the call recipient. Similarly, voice calls originating from the public switched telephone network and destined for a US LEC customer are routed through the US LEC switch and delivered to call recipients via leased transmission facilities.

In order to interconnect its switches to the network of the local incumbent phone company and to exchange traffic with it, the Company maintains interconnection agreements with the incumbent carriers. The Telecommunications Act of 1996 (the "Telecom Act"), decisions of state and federal regulatory bodies and negotiation affect the terms and conditions of the interconnection agreements with the carriers involved. The Company may voluntarily enter into such an agreement, petition a state regulatory commission to arbitrate issues that cannot be resolved by negotiation or opt into agreements executed by the incumbent and other competitive carriers. The Company has signed or opted into interconnection agreements with all of the incumbent local carriers where it offers services requiring such agreements, including BellSouth Telecommunications, Inc. ("BellSouth"), Verizon Communications Inc. ("Verizon") and Sprint Communications Company L.P. ("Sprint"). (See "Business—Forward Looking Statements and Risk Factors—Interconnection Agreements")

PRODUCTS AND SERVICES

The Company provides local dial-tone services to customers. Local access is available in many different forms including Primary Rate Interface ("PRI"), T-1 and channels. The Company's network is designed to allow a customer to easily increase or decrease capacity and utilize enhanced services as the telecommunications requirements of the customer change. The Company also offers directory assistance and operator services.

US LEC provides long distance services for completing intrastate, interstate and international calls. The Company also provides toll-free services, calling cards, audio conferencing and certain enhanced services such as voice mail.

The Company also provides data products including frame relay, ATM service, digital private line and other services.

In addition, US LEC provides Internet products including US LECnet (a direct, dedicated, high-speed connection to the Internet), Web hosting, dial-up access to the Internet, email, managed firewalls and IP-VPN, news feeds and other services.

The Company's ability to bundle local, long distance, data and Internet services on the same transport facility allows it to offer customers more efficient use of such facilities, and allows it to aggregate customers' monthly recurring and usage charges on a single consolidated invoice.

The Company offers the ADVANTAGE T, a single-rate, bundled product offering which allows customers to put local, long distance, dedicated high-speed Internet access, frame relay, ATM, digital private line and toll-free services all on a single T-1. Not only can customers choose between multiple products to be carried, but they can also allocate bandwidth dedicated to each product on the T-1. Management believes that this product allows US LEC to address a broader market.

During 2002, the Company continued to expand its voice, data and Internet product offerings, while minimizing the capital requirements associated with product expansions. The goal of these product expansions was to complete an already strong product set in order to complete customer communications solutions and add incremental revenue opportunities. As an example, US LEC added "reservation-less" Audio Conferencing and various toll free features to its voice product set and Integrated Access Devices, as well as SLA Reporting and Managed Routers and Managed Firewall and IP-VPN to its data and Internet product sets.

SALES AND MARKETING

Sales. US LEC employs a well-trained and experienced direct sales force. The Company recruits salespeople with strong sales backgrounds in its markets, including salespeople from other telecommunications carriers, including long distance companies, CLECs and ILECs, Internet Service Providers, telecommunications equipment manufacturers, and network systems integrators. The Company plans to continue to attract and retain highly qualified salespeople by offering them an opportunity to work with an experienced management team in an entrepreneurial environment and to participate in the potential economic rewards made available through a results-oriented compensation program. In 2000, US LEC implemented the Customer Account Manager ("CAM") program in an effort to gain additional sales from current customers and to enhance the Company's relationships with its customer base. The Company also utilizes independent sales agents to identify and maintain customers. During 2002, the Company continued to enhance its sales force by hiring additional quota-bearing and sales support staff, continuing education regarding the Company's voice, data and Internet products and forming an overlay group to focus on large target customers and data sales.

Marketing. In its existing markets, US LEC seeks to be the premier communications partner for businesses by delivering quality voice and data services and exceeding expectations for customer care. The Company builds its reputation and brand identity by working closely with its customers to develop services customized to their particular needs and by implementing targeted product offerings and promotional efforts.

The Company primarily uses two trademarks and service marks: US LEC, and a logo that includes US LEC. These marks have been registered either on the Principal or the Supplemental Register of the United States Patent and Trademark Office for uses related to telecommunications products and services.

Billing. The Company operates its billing function in-house, allowing the Company to realize cost savings and provide additional services to customers. Customer bills are available in a variety of formats to meet a customer's specific needs. US LEC offers customers simplicity and convenience by sending one bill for all services. The Company believes this is an important aspect of customer acquisition and retention.

EMPLOYEES

As of December 31, 2002, the Company employed 911 people. The Company does not expect significant changes in its staffing level in 2003. The Company considers its employee relations to be very good.

REGULATION

The following summary of regulatory developments and legislation does not purport to describe all present and proposed federal, state and local regulations and legislation affecting the telecommunications industry. Other existing federal and state legislation and regulations are currently the subject of judicial proceedings and legislation, legislative hearings and administrative proposals which could change, in varying degrees, the manner in which this industry operates. Neither the outcome of these proceedings and legislation, nor their impact upon the telecommunications industry or the Company, can be predicted at this time. This section also includes a brief description of regulatory and tariff issues pertaining to the operation of the Company.

Overview. The Company's services are subject to varying degrees of federal, state and local regulation. The Federal Communications Commission (the "FCC") generally exercises jurisdiction over the facilities of, and services offered by, telecommunications common carriers that provide interstate or international communications. The state regulatory commissions ("PUCs") retain jurisdiction over the same facilities and services to the extent they are used to provide intrastate communications.

Federal Legislation. The Company must comply with the requirements of common carriage under the Communications Act of 1934, as amended (the "Communications Act"). The Telecom Act, enacted on February 8, 1996, substantially revised the Communications Act. The Telecom Act establishes a regulatory framework for the introduction of local competition throughout the United States and was intended to reduce unnecessary regulation to the greatest extent possible. Among other things, the Telecom Act preempts, after notice and an opportunity for comment, any state or local government from prohibiting any entity from providing telecommunications service.

The Telecom Act also establishes a dual federal-state regulatory scheme for eliminating other barriers to competition faced by competitors to the incumbent local exchange carriers and other new entrants into the local telephone market. Specifically, the Telecom Act imposes on ILECs certain interconnection obligations, some of which are implemented by FCC regulations. The Telecom Act contemplates that state PUCs will apply the federal regulations and oversee the implementation of all aspects of interconnection not subject to FCC jurisdiction as they oversee interconnection negotiations between ILECs and their new competitors.

The FCC has significant responsibility in the manner in which the Telecom Act will be implemented especially in the areas of pricing, universal service, access charges and price caps. The details of the rules adopted by the FCC will have a significant effect in determining the extent to which barriers to competition in local services are removed, as well as the time frame within which such barriers are eliminated.

The PUCs also have significant responsibility for implementing the Telecom Act. Specifically, the states have authority to establish interconnection pricing, including unbundled loop charges, reciprocal compensation and wholesale pricing consistent with FCC regulations. The PUCs are also charged under the Telecom Act with overseeing the arbitration process for resolving interconnection negotiation disputes between CLECs and the ILECs, must approve negotiated or arbitrated interconnection agreements, and resolve contract compliance disputes arising from interconnection agreements. The U.S. Supreme Court appears to have assumed, without actually deciding that the PUCs have the ability to enforce interconnection agreements.

The Company has historically earned a significant portion of its revenue from the ILEC in the form of reciprocal compensation payments due to the Company. Several ILECs in the Company's territory (principally BellSouth and Verizon) have challenged the applicability of reciprocal compensation related to enhanced service providers and internet service provider ("ISP") customers who receive more calls than they make. With increasing frequency the ILECs with whom US LEC interconnects (principally BellSouth and Verizon) have been raising additional objections to their obligations to pay reciprocal compensation, including challenges to the rates at which such payments are calculated and the types of traffic to with the obligations apply (See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Disputed Revenues").

The obligations imposed on ILECs by the Telecom Act to promote competition, such as local number portability, dialing parity, reciprocal compensation arrangements and non-discriminatory access to telephone poles, ducts, conduits and rights-of-way also apply to CLECs, including the Company. As a result of the Telecom Act's applicability to other telecommunications carriers, it may provide the Company with the ability to reduce its own interconnection costs by interconnecting directly with non-ILECs, but may also cause the Company to incur additional administrative and regulatory expenses in responding to interconnection requests. At the same time, the Telecom Act also makes competitive entry into other service or geographic markets more attractive to Regional Bell Operating Companies ("RBOCs"), other ILECs, long distance carriers and other companies and has increased and likely will continue to increase the level of competition the Company faces. (See "Business—Competition").

In addition, the Telecom Act provided that ILECs that are subsidiaries of RBOCs could not offer in-region, long distance services across local access transport areas ("LATAs") until they had demonstrated that (i) they have entered into an approved interconnection agreement with a facilities-based CLEC or that no such CLEC has requested interconnection as of a statutorily determined deadline, (ii) they have satisfied a 14-element checklist designed to ensure that the ILEC is offering access and interconnection to all local exchange carriers on competitive terms and (iii) the FCC has determined that in-region, inter-LATA approval is consistent with the public interest, convenience and necessity. The FCC has approved Verizon's right to provide interLATA service in Connecticut, Delaware, District of Columbia, Maryland, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont, Virginia and West Virginia; BellSouth's right to provide interLATA service in Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina and Tennessee; and SBC Communications, Inc. ("SBCs") in Arkansas, California, Kansas, Missouri, Oklahoma and Texas. (See "Business—Forward Looking Statements and Risk Factors—Regulation" and "Business—Forward Looking Statements and Risk Factors—Competition").

Federal Regulation and Related Proceedings. The Telecom Act and the FCC's efforts to initiate reform have resulted in numerous legal challenges. As a result, the regulatory framework in which the Company operates is subject to a great deal of uncertainty. Any changes that result from this uncertainty could have a material adverse effect on the Company. The FCC has adopted orders prohibiting the use of tariffs for non-dominant carriers providing international and domestic interstate long distance services. Accordingly, non-dominant interstate services providers and international service providers will no longer be able to rely on the filing of end user tariffs with the FCC as a means of providing notice to customers of prices, terms, and conditions under which they offer their international and domestic interstate inter-exchange services. The order does not apply to the switched and special access services of the RBOCs and other local exchange service providers. The FCC allows permissive detariffing of these services.

The FCC also has proposed reducing the level of regulation that applies to the ILECs, and increasing their ability to respond quickly to competition from the Company and others. For example, in accordance with the Telecom Act, the FCC has applied "streamlined" tariff regulation to the ILECs, which greatly accelerates the time prior to which changes to tariffed service rates may take effect, and has eliminated the requirement that ILECs obtain FCC authorization before constructing new domestic facilities. These actions will allow ILECs to change service rates more quickly in response to competition. Similarly, the FCC has afforded significant new pricing flexibility to ILECs subject to price cap regulation. On August 5, 1999, the FCC adopted an order granting price cap ILECs additional pricing flexibility. The order provides certain immediate regulatory relief regarding price cap ILECs and sets forth a framework of "triggers" to provide those companies with greater flexibility to set rates for interstate access services. On February 2, 2001, the D.C. Circuit upheld the FCC rules regarding pricing flexibility. To the extent such increased pricing flexibility is utilized for ILECs or such additional regulation is implemented, the Company's ability to compete with ILECs for certain service could be adversely affected. The FCC has granted pricing flexibility applications for various interstate access services provided by RBOCs in a number of cities, including cities in BellSouth's service territory, including in several of the Company's markets.

On August 8, 1996, the FCC issued an order containing rules providing guidance to the ILECs, CLECs, long distance companies and PUCs regarding several provisions of the Telecom Act. The rules include, among other things, FCC guidance on: (i) discounts for end-to-end resale of ILEC retail local exchange services (which the FCC suggested should be in the range of 17%-25%); (ii) availability of unbundled local loops and other unbundled ILEC network elements; (iii) the use of Total Element Long Run Incremental Costs in the pricing of these unbundled network elements; (iv) average default proxy prices for unbundled local loops in each state; (v) mutual compensation proxy rates for termination of ILEC/CLEC local calls; and (vi) the ability of CLECs and other service providers to opt into portions of previously-approved interconnection agreements negotiated by the ILECs with other parties on a most favored nation (or a "pick and choose") basis.

Various parties, including ILECs and state PUCs, requested that the FCC reconsider its own rules and/or filed appeals of the FCC's August 8, 1996 order. The U.S. Court of Appeals for the Eighth Circuit ("8th Circuit") vacated certain portions of the decision. On January 25, 1999, U.S. Supreme Court reversed the 8th Circuit and upheld the FCC's authority to issue regulations governing pricing of unbundled network elements ("UNEs") provided by the ILECs in interconnection agreements (including regulations governing reciprocal compensation). In addition, the U.S. Supreme Court affirmed the "pick and choose" rules which allows carriers to choose individual portions of existing interconnection agreements with other carriers and to adopt only those portions of the interconnection agreement that they find most attractive. The U.S. Supreme Court disagreed with the standard applied by the FCC for determining whether an ILEC should be required to provide a competitor with particular unbundled network elements. On remand, the FCC largely retained its list of unbundled elements, but eliminated the requirement that ILECs provide unbundled access to local switching for customers with four or more lines in the top 50 Metropolitan Statistical Areas, and the requirement to provide unbundled operator service and directory assistance.

Additionally, on remand from the Supreme Court, the 8th Circuit rejected the FCC's forward-looking pricing methodology for use in establishing pricing for UNEs. On May 13, 2002, the U. S. Supreme Court issued an opinion reversing the 8th Circuit and upholding the FCC's forward looking pricing methodology for use in establishing pricing for unbundled network elements. The Supreme Court also upheld the FCC's authority to require ILECs who lease elements of their networks to bundle services for CLECs that are unable to bundle the services themselves.

In December 2001, the FCC initiated a comprehensive evaluation of its rules governing the unbundling of network elements. On May 24, 2002, the United States Court of Appeals for the D.C. Circuit overturned two decisions of the FCC. First the court remanded to the FCC for further consideration its decision on UNEs, which required ILECs to lease numerous UNEs to CLECs. Second, the court vacated and remanded the FCC decision requiring ILECs to unbundle a portion of the spectrum of local copper loops so that data local exchange carriers can offer competitive advanced services such as DSL.

The FCC consolidated the issues on UNEs remanded by the D.C. Circuit and its UNE review proceeding. On February 20, 2003, the FCC addressed the remand on UNEs and its comprehensive evaluation of UNEs. Since the FCC has yet to release its formal order on the issue or its underlying rules, the Company cannot assess what impact, if any, they will have on the Company's operations.

On May 8, 1997, the FCC released an order establishing a significantly expanded federal universal service program which subsidized certain eligible services. For example, the FCC established new subsidies for services provided to qualifying schools and libraries with an annual cap of $2.25 billion and for services provided to rural health care providers with an annual cap of $400 million. The FCC also expanded the federal subsidies to low-income consumers and consumers in high-cost areas. Providers of interstate telecommunications service, such as the Company, as well as certain other entities, must pay for these programs. The Company's share of the schools, libraries and rural health care funds is based on its share of the total industry telecommunications service and certain defined telecommunications end user revenues. The Company's share of all other federal subsidy funds is based on its share of the total interstate telecommunications service and certain defined telecommunications end user revenues. Although the Company has made its required contributions to the fund, the amount of the Company's contribution changes each quarter. As a result, the Company cannot predict the effect these regulations will have on the Company in the future. On December 13, 2002, the FCC adopted a Report and Order modifying the current method of carrier contributions to the universal service fund. The revised revenue-based methodology will impose universal service contribution on the basis of projected, collected end user interstate revenues in lieu of historical revenues. This revised methodology is an interim one pending further rulemaking. The interim changes will not have a material effect on the Company.

The FCC has made and is continuing to consider various reforms to the existing rate structure for charges assessed on long distance carriers for allowing them to connect to local networks. These reforms are designed to move these "access charges," over time, to lower, cost-based rate levels and structures. These changes will reduce access charges and will shift charges, which had historically been based on minutes-of-use, to flat-rate, monthly per line charges on end-user customers rather than long distance carriers. On May 31, 2000 the FCC adopted the proposal of the Coalition for Affordable Long Distance Service ("CALLS Order") that significantly restructures and, reduces in some respects, the interstate access charges of the RBOCs, Verizon, AT&T, and Sprint. Among the more significant regulatory changes established by the CALLS Order, the RBOCs and Verizon are required to reduce switched access charges to an average of $0.0055/minute. Price cap ILECs are additionally required to eliminate the pre-subscribed inter-exchange carrier charge ("PICC") as a separate charge and fold it into an increased subscriber line charge ("SLC"). AT&T and Sprint have committed in this proceeding to pass on access charge reductions to consumers, and to eliminate minimum monthly usage charges. Although the CALLS Order will not apply directly to CLECs, ILEC reductions in switched access charges will likely place downward pressure on CLECs, including the Company, to reduce their own switched access charges either in the form of regulatory pressure or commercial pressure from the IXCs. A Petition for Reconsideration of the CALLS Order is currently before the FCC. The CALLS Order was appealed to the U.S. Court of Appeals for the District of Columbia. The Court remanded the case to the FCC.

On May 21, 2001, the FCC's new rules governing CLEC interstate access charges became effective. The rules established an initial maximum rate of 2.5 cents per minute for interstate access charges for the first year. In the second year, the rate was reduced to 1.8 cents per minute. In the third year, the rate is further reduced to 1.2 cents per minute. At the end of the third year, the benchmark rate is reduced to the level of the ILEC. A CLEC may not file tariffs for above benchmark rates unless the ILEC in whose territory it operates charges a higher rate, in which case the CLEC may charge the higher ILEC rate or the rate it had tariffed in the previous six months, if lower than the ILEC's rate. A CLEC may charge a rate higher than the benchmark if the IXC, through negotiations, agrees to such higher rate.

In addition, the FCC only allowed a CLEC to charge the benchmark rates in those areas in which the CLEC was actually serving customers on May 21, 2001. In new service areas, the CLEC may only tariff rates as high as the ILEC. Several petitions for reconsideration of the FCC's order were filed with the FCC, as well as appeals to the U.S. Court of Appeals for the District of Columbia Circuit. The Court granted the FCC's request to hold the appeals in abeyance until the FCC decides the motions for reconsideration. In addition, CLEC access charges are among the intercarrier compensation issues addressed in the FCC's Notice of Proposed Rulemaking regarding a unified intercarrier compensation regime.

In the same order, the FCC determined that an IXC's refusal to serve customers of a CLEC that tariffs the FCC's benchmark rates would generally violate the IXC's duty as a common carrier to provide service.

On February 26, 1999, the FCC issued a declaratory ruling and notice of proposed rulemaking concerning ISP traffic. The FCC concluded in its ruling that ISP traffic is jurisdictionally mixed, but largely interstate in nature. The FCC also determined that no federal rule existed that governed reciprocal compensation for ISP traffic at the time existing interconnection agreements were negotiated and concluded that it should permit PUCs to determine whether reciprocal compensation should be paid for calls to ISPs under existing interconnection agreements. Several parties appealed the FCC order. On March 24, 2000, the United States Court of Appeals for the D.C. Circuit vacated the FCC's February 26, 1999 declaratory ruling and remanded it to the FCC. The D.C. Circuit Court of Appeals found that the FCC failed to clearly explain and support why ISP traffic should be regulated as long distance traffic rather than as local traffic.

On April 27, 2001, the FCC released its Order on Remand regarding intercarrier compensation for ISP-bound traffic. The FCC asserted exclusive jurisdiction over ISP-bound traffic and established a new interim intercarrier compensation regime for ISP-bound traffic with capped rates above a fixed traffic exchange ratio. Traffic in excess of a ratio of 3:1 (terminating minutes to originating minutes) is presumed to be ISP-bound traffic, and is to be compensated at rates that decrease from $.0015 to $.0007 per minute, or the applicable state-approved rate if lower, over three years. Traffic below the 3:1 threshold is to be compensated at the negotiated or PUC-approved rates in existing and future interconnection agreements. Traffic above the 3:1 ratio is also subject to a growth ceiling using first quarter 2001 traffic data as the baseline. Traffic in excess of the growth ceiling is subject to "bill and keep," an arrangement in which the originating carrier pays no compensation to the terminating carrier to complete calls. In addition, when a competitive carrier begins to provide service in a state it has not previously served, all traffic in excess of the 3:1 ratio is subject to bill-and-keep arrangements. In exchange for this reduction in reciprocal compensation obligations to CLECs, the ILECs must offer to exchange all traffic subject to Section 251 (b) (5) of the Telecommunications Act of 1996, as well as ISP-bound traffic, at the federal capped rates. It is not possible to estimate the full impact of the FCC Order at this time because the federal regime does not alter existing contracts except to the extent that they incorporate changes of federal law, and because adoption of the federal regime is within the discretion of the ILEC exchanging traffic with CLECs on a state-by-state basis. In addition, the rules are the subject of petitions for reconsideration before the FCC. On May 3, 2002, the U.S. Court of Appeals for the D.C. Circuit found that the FCC had again failed to justify its stance on Section 2521(g) of the Telecom Act in adopting its new intercarrier compensation regime. The court remanded the case to the FCC for further explanation of its legal theory. In the interim, the court allowed the FCC's compensation rules to stand. A petition for certiorari has been filed with the U.S. Supreme Court challenging the Court of Appeals' failure to vacate the interim rules as part of the remand to the FCC. In the event an ILEC determines not to adopt the federal regime, the ILEC must pay the same rate for ISP bound traffic as for calls subject to reciprocal compensation. We cannot predict the impact of the FCC's and the Court's ruling on existing state decisions the outcome of pending appeals or future litigation on this issue.

The FCC also requires carriers to file periodic reports concerning carrier's interstate circuits and deployment of network facilities. The FCC generally does not exercise direct oversight over cost justification and the level of charges for services of non-dominant carriers, although it has the power to do so. The FCC also imposes prior approval requirements on transfers of control and assignments of operating authorizations. The FCC has the authority to generally condition, modify, cancel, terminate, or revoke operating authority for failure to comply with federal laws or rules, regulations and policies of the FCC. Fines or other penalties also may be imposed for such violations. Although the Company believes it is in compliance with all applicable laws and regulations, there can be no assurance that the FCC or third parties will not raise issues with regard to the Company's compliance with such laws and regulations.

The FCC has initiated rulemaking proceedings to consider whether advanced services offered by ILECs should be regulated as services offered by a dominant or nondominant carrier. If the service offerings are deemed nondominant, the ILEC will be subject to lessened regulation. In a related proceeding, the FCC is seeking to determine whether advanced services are information services and what regulations should apply, if that is the case. A finding that advanced services are information services, and not telephone services, could result in significantly lower levels of regulation. The Company cannot predict the outcome of these proceedings.

In December 1996, the FCC initiated a Notice of Inquiry regarding whether to impose regulations or surcharges upon providers of Internet access and information services (the "Internet NOI"). The Internet NOI sought public comment upon whether to impose or continue to forebear from regulation of Internet and other packet-switched network service providers. The Internet NOI specifically identifies Internet telephony as a subject for FCC consideration. On April 10, 1998, the FCC issued a Report to Congress on its implementation of the universal service provisions of the Telecom Act. In the Report, the FCC indicated that it would examine the question of whether certain forms of "phone-to-phone Internet Protocol telephony" are information services or telecommunications services. It noted that the FCC did not have an adequate record on which to make any definitive pronouncements on that issue at this time, but that the record the FCC had reviewed suggests that certain forms of phone-to-phone Internet Protocol telephony appear to have similar functionality to non-Internet Protocol telecommunications services and lack the characteristics that would render them information services. If the FCC were to determine that certain Internet Protocol telephony services are subject to FCC regulations as telecommunications services, the FCC noted it may find it reasonable that the ISPs that provide those services pay access charges and make universal service contributions similar to non-Internet Protocol based telecommunications service providers. The FCC also noted that other forms of Internet Protocol telephony appear to be information services.

On October 18, 2002, AT&T Corporation ("AT&T") filed a petition for declaratory ruling with the FCC with respect to phone-to-phone Internet Protocol telephony. The petition requested that the FCC affirm that such services are exempt from the access charges applicable to circuit switched inter-exchange calls and that it is lawful to provide such service through local end user services. Comments were filed with the FCC in response to the AT&T petition, and it is unclear when the FCC might rule on the question presented. The Company cannot predict the outcome of these proceedings or other FCC or state proceedings that may affect the Company's operations or impose additional requirements, regulations or charges upon the Company's provision of Internet access and related Internet Protocol-based telephony services.

Slamming. The FCC and many state PUCs have implemented rules to prevent unauthorized changes in a customer's pre-subscribed local and long distance carrier (a practice commonly known as "slamming.") Pursuant to the FCC's slamming rules, a carrier found to have slammed a customer is subject to substantial fines. In addition, the FCC's slamming rules were revised effective November 2000 to include new provisions governing liability for slamming, and provisions allowing state PUCs to elect to administer and enforce the FCC's slamming rules. These slamming liability rules substantially increase a carrier's possible liability for unauthorized carrier changes, and may substantially increase a carrier's administrative costs in connection with alleged unauthorized carrier changes (even if the carrier can provide valid proof that such changes were authorized). Although the Company cannot predict the effect that these new liability rules will have on its business, because virtually all of the Company's customers are connected on a dedicated basis to US LEC's network, it is unlikely that the Company will incur any significant liability under these new rules.

The Communications Assistance for Law Enforcement Act ("CALEA") provides rules to ensure that law enforcement agencies would be able to conduct properly authorized electronic surveillance of digital and wireless telecommunication services. CALEA requires telecommunications carriers to modify their equipment, facilities, and services used to provide telecommunications services to ensure that they are able to comply with authorized electronic surveillance requirements. For circuit-switched facilities, carriers were required to complete these modifications by June 30, 2001. Carriers providing packet-switched services were required to comply by November 19, 2001. The deadline for carrier compliance with certain additional requirements has been extended by the FCC until June 30, 2002. US LEC's network is CALEA compliant.

State Regulation. The Company has all of the state certifications necessary to offer its current services.

To the extent that an area within a state in which the Company operates is served by a small (in line counts) or rural ILEC not currently subject to competition, the Company generally does not have authority to service those areas at this time. Most states regulate entry into local exchange and other intrastate service markets, and states' regulation of CLECs vary in their regulatory intensity. The majority of states mandate that companies seeking to provide local exchange and other intrastate services apply for and obtain the requisite authorization from the PUC. This authorization process generally requires the carrier to demonstrate that it has sufficient financial, technical, and managerial capabilities and that granting the authorization will serve the public interest.

As a CLEC, the Company is subject to the regulatory directives of each state in which the Company is certified. In addition to tariff filing requirements, most states require that CLECs charge just and reasonable rates and not discriminate among similarly situated customers. Some states also require the filing of periodic reports, the payment of various regulatory fees and surcharges, and compliance with service standards and consumer protection rules. States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of a CLEC. States generally retain the right to sanction a carrier or to revoke certifications if a carrier violates relevant laws and/or regulations.

In all of the states where US LEC is certified, the Company is required to file tariffs or price lists setting forth the terms, conditions and/or prices for services which are classified as intrastate. In some states, the Company's tariff may list a range of prices or a ceiling price for particular services, and in others, such prices can be set on an individual customer basis, although the Company may be required to file tariff addenda of the contract terms. The Company is not subject to price cap or to rate of return regulation in any state in which it currently provides services. Some states where the Company operates have adopted detariffing rules.

As noted above, the states have the primary regulatory role over intrastate services under the Telecom Act. The Telecom Act allows state regulatory authorities to continue to impose competitively neutral and nondiscriminatory requirements designed to promote universal service, protect the public safety and welfare, maintain the quality of service and safeguard the rights of consumers. PUCs will implement and enforce most of the Telecom Act's local competition provisions, including those governing the specific charges for local network interconnection. In some states, those charges are being determined by generic cost proceedings and in other states they are being established through arbitration proceedings. Depending on how such charges are ultimately determined, such charges could become a material expense to the Company.

COMPETITION

ILECs. In each market served by its networks, the Company faces, and expects to continue facing, significant competition from the ILECs, which currently dominate their local telecommunications markets as a result of their historic monopoly position. The ILECs have also recently entered the long distance markets in parts of their service areas. They also offer data and Internet services.

The Company competes with the ILECs in its markets for local exchange services on the basis of product offerings, bundling, reliability, state-of-the-art technology, price, network design, ease of ordering and customer service. However, the ILECs have long-standing relationships with their customers and provide those customers with various transmission and switching services, a number of which the Company does not currently offer. In addition, ILECs enjoy a competitive advantage due to their vast financial resources. The Company has sought, and will continue to seek, to achieve parity with the ILECs in order to become able to provide a full range of local telecommunications services. (See "Business—Regulation" for additional information concerning the regulatory environment in which the Company operates.) Because US LEC leases fiber optic transmission capacity to link its customers with its networks and uses state-of- the-art technology in its switching platforms, the Company has demonstrated bundling, cost and service quality advantages over some ILEC networks currently available.

IXCs. Interexchange carriers that provide long distance services and other telecommunications services offer or have the capability to offer switched local, long distance, data and Internet services. Some of these carriers have a much larger service footprint than the Company.

Other CLECs. In every market where US LEC has a switching center, one or more other CLECs are also operating. In some cases, the Company competes head-to-head with other CLECs and in some cases the other CLECs seek to serve a different customer base. The Company competes with other CLECs in its markets on the basis of product offerings, bundling, reliability, state-of-the-art technology, price, network design, ease of ordering and customer service. Some of these carriers have entered bankruptcy and some of these are expected to exit bankruptcy in 2003.

Internet Service Providers (ISPs). Throughout the Company's service area, various Internet service providers also operate. In some cases, the Company competes head-to-head with other ISPs and in some cases, the other ISPs seek to serve a different customer base. The Company competes with other ISPs in its markets on the basis of product offerings, bundling, reliability, state-of-the-art technology, price, network design, ease of ordering and customer service. Some of these carriers have entered bankruptcy and some of these are expected to exit bankruptcy in 2003.

Other Competitors. The Company also faces, and expects to continue facing, competition from other potential competitors in certain markets in which the Company offers services. In addition to the ILECs, IXCs and other CLECs, potential competitors capable of offering switched local and long distance services include long distance carriers, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end-users. Many of these potential competitors enjoy competitive advantages based upon existing relationships with subscribers, brand name recognition and vast financial resources. A continuing trend toward business combinations and alliances in the telecommunications industry may create significant new competitors to the Company.

The Company believes that the Telecom Act, as well as a recent series of completed and proposed transactions between ILECs and long distance companies and cable companies, increase the likelihood that barriers to local exchange competition will be removed. The Telecom Act, as passed, conditioned the provision of in-region interLATA services by RBOCs upon a demonstration that the market in which an RBOC seeks to provide such services has been opened to competition. As ILECs that are RBOC subsidiaries are permitted to provide such services more widely, they will be in a position to offer single-source service, representing a significant competitive challenge for the Company. ILECs that are not RBOC subsidiaries may offer single-source service presently. The Telecom Act's limitations on the provisioning of in-region interLATA services have been challenged by the RBOCs. The FCC has approved Verizon's and BellSouth's right to provide interLATA service in the states in which the Company operates. (see "Business—Regulation").

The Company also competes with long distance carriers in the provisioning of long distance services. Although a few major competitors dominate the long distance and data market, hundreds of other companies also compete in the long distance and data marketplace.

FORWARD LOOKING STATEMENTS AND RISK FACTORS

Except for historical statements and discussions, statements contained in this report constitute "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In addition, the Company's Annual Report to Stockholders for the year ended December 31, 2002, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and subsequently filed Annual Reports on Form 10-K, may include forward looking statements. Other written or oral statements which constitute forward looking statements have been made and may in the future be made by or on behalf of US LEC. These statements are identified by the use of forward-looking terminology such as "believes," "expects," "may," "will," "should," "estimates" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. These forward looking statements are based on a number of assumptions concerning future events, including the outcome of judicial and regulatory proceedings, the adoption of balanced and effective rules and regulations by the FCC and PUCs, and US LEC's ability to successfully execute its strategy. These forward looking statements are also subject to a number of uncertainties and risks, many of which are outside of US LEC's control, that could cause actual results to differ materially from such statements. These risks include, but are not limited to, the following:

Disputed Revenues. The deregulation of the telecommunications industry, the implementation of the Telecom Act, and the financial distress of many carriers in the wake of the downturn in the telecommunications industry have embroiled numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company. These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, the applicability of access rates to wireless traffic, rates applicable to different categories of traffic, and the characterization of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations, and proceedings over these and other material issues (see "Management's Discussion and Analysis of Financial Condition and Results of Operation—Disputed Revenues"). The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of operations.

Risks Associated with Strategy. The operation, construction, expansion and development of US LEC's operations depend on, among other things, the Company's ability to continue to (i) accurately assess potential new markets and products, (ii) identify, hire and retain qualified personnel, (iii) lease access to suitable fiber optic transmission facilities, (iv) install and operate switches and related equipment and (v) obtain any required government authorizations, all in a timely manner, at reasonable costs and on satisfactory terms and conditions. In addition, US LEC has experienced rapid growth since its inception, and management believes that sustained growth will place a strain on operational, human and financial resources. The Company's ability to manage its operations and expansion effectively depends on the continued development of plans, systems and controls for its operational, financial and management needs. There can be no assurance that the Company will be able to satisfy these requirements or otherwise manage its operations and growth effectively. The failure of US LEC to satisfy these requirements could have a material adverse effect on the Company's financial condition and its ability to fully implement its operating plans.

The Company's growth strategy also involves the following risks:

Qualified Personnel. A critical component for US LEC's success is hiring and retaining additional qualified managerial, sales and technical personnel. Since its inception, the Company has experienced significant competition in hiring and retaining personnel possessing necessary skills and telecommunications experience. Although management believes the Company has been successful in hiring and retaining qualified personnel, there can be no assurance that US LEC will be able to do so in the future.

Switches and Related Equipment. An essential element of the Company's current strategy is the provision of switched voice and data services. There can be no assurance that the switches and associated equipment necessary to operate the Company's network will not experience technological or operational problems that cannot be resolved in a satisfactory or timely matter. The failure of the Company to operate successfully switches and other network equipment could have a material adverse effect on the Company's financial condition and its ability to attract and retain customers or to enter additional markets.

Interconnection Agreements. The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, the Company will be required to negotiate extension or replacement agreements. There can be no assurance that the Company will successfully negotiate such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company. The Company has signed interconnection agreements with various ILECs, including BellSouth, Sprint, Verizon and other carriers. These agreements provide the framework for the Company to serve its customers when other local carriers are involved.

Ordering, Provisioning and Billing. The Company has developed processes and procedures and is working with external vendors, including the ILECs, in the implementation of customer orders for services, the provisioning, installation and delivery of such services and monthly billing for those services. The failure to effectively manage processes and systems for these service elements or the failure of the Company's current vendors or the ILECs to deliver ordering, provisioning and billing services on a timely and accurate basis could have a material adverse effect upon the Company's ability to fully execute its strategy.

Products and Services. The Company currently offers local, long distance, data, Internet and other telecommunications services. In order to address the needs of its target customers, the Company will be required to emphasize and develop additional products and services. No assurance can be given that the Company will be able to continue to provide the range of telecommunication services that its target customers need or desire.

Acquisitions. US LEC may acquire other businesses as a means of growing its customer base, expanding into new markets or developing new services. The Company is unable to predict whether or when any prospective acquisitions will occur or the likelihood of a material transaction being completed on favorable terms and conditions. Such transactions would involve certain risks including, but not limited to, (i) difficulties assimilating acquired operations and personnel; (ii) potential disruptions of the Company's ongoing business;

(iii) the diversion of resources and management time; (iv) the possibility that uniform standards, controls, procedures and policies may not be maintained; (v) risks associated with entering new markets in which the Company has little or no experience; and (vi) the potential impairment of relationships with employees or customers as a result of changes in management. If an acquisition were to be made, there can be no assurance that the Company would be able to obtain the financing to consummate any such acquisition on terms satisfactory to it or that the acquired business would perform as expected.

Dependence on Key Personnel. The Company's business is managed by a small number of executive officers, most notably, Aaron D. Cowell, Jr., Chief Executive Officer and President, and Michael K. Robinson, Executive Vice President and Chief Financial Officer. The loss of the services of one or more of these key people could materially and adversely affect US LEC's business and its prospects. The Company does not maintain key man life insurance on any of its officers. The competition for qualified managers in the telecommunications industry is intense. Accordingly, there can be no assurance that US LEC will be able to hire and retain necessary personnel in the future to replace any of its key executive officers, if any of them were to leave US LEC or be otherwise unable to provide services to US LEC.

Reliance on Leased Capacity. A key element of US LEC's business and growth strategy is leasing fiber optic transmission capacity instead of constructing its own transport facilities. In implementing this strategy, the Company relies upon its ability to lease capacity from CAPs, other CLECs and ILECs operating in its markets. In order for this strategy to be successful, the Company must be able to negotiate and renew satisfactory agreements with its fiber optic network providers, and the providers must process provisioning requests on a timely basis, maintain their networks in good working order and provide adequate capacity at competitive prices. Although US LEC enters into agreements with its network providers that are intended to ensure access to adequate capacity and timely processing of provisioning requests and although US LEC's interconnection agreements with ILECs generally provide that the Company's connection and maintenance orders will receive attention at parity with the ILECs and other CLECs and that adequate capacity will be provided, there can be no assurance that the ILECs and other network providers will comply with their contractual (and, in the case of the ILECs, legally required) network provisioning obligations, or that the provisioning process will be completed for the Company's customers on a timely and otherwise satisfactory basis. Furthermore, there can be no assurance that the rates to be charged to US LEC under future interconnection agreements or lease agreements with other providers will allow the Company to offer usage rates low enough to attract a sufficient number of customers and operate its networks at satisfactory margins.

Competition. The telecommunications industry is highly competitive. In each of the Company's existing and target markets, the Company competes and will continue to compete principally with the ILECs serving that area. ILECs are established providers of local telephone and exchange access services to all or virtually all telephone subscribers within their respective service areas. ILECs also have greater financial and personnel resources, brand name recognition and long-standing relationships with customers and with regulatory authorities at the federal and state levels and with most long distance carriers. Now that the RBOC subsidiaries in most states in which the Company operates are authorized to provide in-region long distance services, there can be no assurance that there will not be increased competition from those ILECs.

The Company also faces, and expects to continue to face, competition from other current and potential market entrants, including long distance carriers seeking to enter, reenter or expand entry into the local exchange marketplace, and from other CLECs, CAPs, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end-users. In addition, the possibility of combinations and strategic alliances in the telecommunications industry could give rise to significant new competitors. Many of these current and potential competitors have financial, personnel and other resources, including brand name recognition, substantially greater than those of the Company, as well as other competitive advantages over the Company. In addition, some competitors are now emerging from the protection of Chapter 11 with dramatically altered financial structures that could give those entities the ability to offer more competitive rates than the Company.

The Company also competes with long distance carriers in the provisioning of long distance services. Although a few major competitors dominate the long distance and data market, hundreds of other companies also compete in the long distance and data marketplace.

In addition, the regulatory environment in which the Company operates is undergoing significant change. As this regulatory environment evolves, changes may occur which could create greater or unique competitive advantages for all or some of the Company's current or potential competitors, or could make it easier for additional parties to provide services. (See "Business—Competition").

At December 31, 2002, the Company was providing services to over 10,000 customers. A key element of the Company's future success will depend on its ability to retain these customers and minimize loss of revenue associated with customer or product churn. While the Company has historically achieved significant success in retaining customers, competition in the Company's marketplace is intense and the Company anticipates that other carriers will seek to persuade the Company's customers to switch service provided for some or all of their products.

Regulation. Although passage of the Telecom Act has resulted in increased opportunities for companies that are competing with the ILECs, no assurance can be given that changes in current or future regulations adopted by the FCC or state regulators or other legislative or judicial initiatives relating to the telecommunications industry would not have a material adverse effect on the Company. In addition, although the Telecom Act, as passed, conditioned RBOCs' provisioning of in-region long distance service on a showing that the local market has been opened to competition, in the event a RBOC has satisfied these conditions, it could (i) remove the incentive RBOCs presently have to cooperate with companies like US LEC to foster competition within their service areas so that they can qualify to offer in-region long distance by allowing RBOCs to offer such services immediately and (ii) give the RBOCs the ability to offer "one-stop shopping" for both long distance and local service. Since the RBOC subsidiary in almost every state in which the Company operates has been authorized to provide in-region long distance services, there can be no assurances that those RBOC subsidiaries will continue to cooperate willingly with the Company in the provision of services.

In addition to the specific concerns regarding the RBOCs ability to provide in-region long distance, the regulatory environment facing the Company is subject to numerous uncertainties. The FCC and PUC orders that were designed to implement the Telecom Act have been challenged in numerous proceedings. As a result, the Company must attempt to execute its business strategy without knowing the rules that will govern its operations and its dealings with other telecommunications companies, including the rates and terms under which it may charge other carriers for reciprocal compensation and other access charges. Even though a number of the past regulatory efforts by the FCC and PUCs are or have been challenged, the Company expects further rule making from the FCC and PUCs. The outcome of these challenges and the nature and scope of future rule making are unknown. In particular, the Company anticipates further efforts by other carriers, primarily ILECs and IXCs, at the FCC, PUCs and in legislative initiatives to seek to cap, reduce and/or eliminate reciprocal compensation and to cap or significantly reduce other access charges. The Company cannot predict the degree to which the ILECs and IXCs will be successful in such efforts, or, if they are, when such additional changes will take effect. If such changes result in a significant decrease in the rates which the Company may charge other carriers for reciprocal compensation and access or if such changes are retroactive, such changes could have a material adverse effect on the Company.

As the regulatory environment changes, it is possible that the Company's strategy and its execution of the strategy may not be the optimal choice. Any such changes could also result in additional, unanticipated expenses. There can be no assurances that regulatory change will not have a material and adverse effect on the Company. (See "Business—Regulation")

Legal Proceedings. The Company is currently involved in arbitral, administrative and judicial proceedings and appeals thereof to collect amounts owed to the Company by other carriers. US LEC filed a Petition for Declaratory Ruling with the FCC requesting that the FCC reaffirm its prior positions that access charges can be collected by local exchange carriers in connection with calls originating or terminating on the networks of wireless carriers. A number of different carriers have filed comments in support of, and in opposition to, US LEC's petition. In addition ITC^DeltaCom Communications, Inc. ("ITC") has filed a lawsuit against the Company alleging that in an effort to collect access charges from ITC for originating wireless traffic destined for ITCs toll-free customer, US LEC blocked certain signaling data for calls originated on the networks of US LEC's wireless carrier customers that would allow the call to be identified as a wireless call. ITC's lawsuit alleges claims based on a number of different legal theories. US LEC, through counsel, has investigated ITC's allegations, and has discovered no evidence to support ITC's claims. US LEC has denied ITC's allegation and asserted a counterclaim against ITC to recover outstanding access charges owed by ITC. The Company anticipates dispositive motions will be filed shortly as the Company seeks early resolution of the case. In addition to the lawsuit filed in federal court, ITC also filed an Informal Complaint at the FCC challenging US LEC's right to recover access charges on calls originating from wireless carriers. The informal complaint was closed without the FCC taking any action. The Company also received a separate request for information from the Enforcement Bureau of the FCC concerning the Company's billing for wireless traffic and its methods of billing. The Company intends to respond to the FCC's requests. Further, the Company will discuss with the FCC its belief that no additional proceedings are warranted by the agency beyond those already pending on the issue of terminating calls originating on the networks of wireless carriers, including the proceeding commenced by US LEC requesting guidance to the industry on the issue. If the FCC does not reaffirm its prior guidance, the inability of US LEC to recover access charges from IXCs for traffic originating on the networks of wireless carrier customers could have a material negative impact on US LEC's results of operations.

The Company cannot predict when these matters will be formally resolved and, although Management anticipates that these pending actions and appeals will be resolved favorably, no assurance can be given that the Company will be ultimately successful in these actions or the appeals thereof or that the Company will collect all amounts that it believes to be due it from these other carriers, or that if it does collect some or all of the award due to it, when payment of the awards will be received or whether the FCC will reaffirm its prior guidance on the applicability of access charges to wireless traffic (see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Disputed Revenues").

Future Capital and Operating Requirements. Implementation of the Company's business strategy will require significant capital and operating expenditures during 2003 and future years. The Company's principal capital expenditures relate to the expansion of its switching platform, related infrastructure and facilities. Management expects to satisfy its capital and operating requirements primarily with current cash balances and cash flow from operations, although there can be no assurance that the actual expenditures required to implement the Company's business strategy will not exceed amounts available from these sources. In addition, the actual amount and timing of the Company's future expenditures may differ materially from the Company's estimates as a result of, among other things, the number of its customers and the services for which they subscribe and regulatory, technological and competitive developments in the Company's industry. Due to the uncertainty of these factors, actual revenues and costs may vary from expected amounts, possibly to a material degree, and such variations are likely to affect the implementation of the Company's business strategy.

The Company also will continue to evaluate revenue opportunities in existing and other markets as well as potential acquisitions. The Company expects to obtain the capital required to pursue expansion and acquisition opportunities from current cash balances, the sale of additional equity or debt securities or cash generated from operations. In light of the risk factors discussed herein, there can be no assurance, however, that the Company will be successful in raising sufficient additional capital on acceptable terms or that the Company's operations will produce sufficient positive cash flow to pursue such opportunities should they arise. Failure to raise and generate sufficient funds, or unanticipated increases in capital requirements may require the Company to delay or curtail its expansion plans, which could have a material adverse effect on the Company's growth and its ability to compete in the telecommunications services industry. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources.")

Executive Officers of the Registrant

The following table sets forth certain information regarding the executive officers of US LEC Corp:

Name	Age	Position
Richard T. Aab	54	Chairman of the Board and Director
Aaron D. Cowell, Jr.	40	President, Chief Executive Officer and Director
Michael K. Robinson	46	Chief Financial Officer and Executive Vice President

Richard T. Aab co-founded US LEC in June 1996 and has served as chairman of the board of directors since that time. He also served as chief executive officer from June 1996 until July 1999. Between 1982 and 1997, Mr. Aab co-founded ACC Corp., an international telecommunications company in Rochester, NY, and held various positions including chairman and chief executive officer, and served as a director.

Aaron D. Cowell, Jr. joined US LEC in June 1998 as executive vice president and general counsel. Later that year, he assumed responsibility for US LEC's sales and field sales support functions. In 1999, his executive management duties were expanded to include US LEC's engineering, operations, regulatory, customer care services and marketing departments. He was appointed as president and chief operating officer of US LEC in 2000. In October 2002, Mr. Cowell was also named chief executive officer and was elected to the board of directors. He also holds a position on the Executive Committee for ALTS (The Association for Local Telecommunications Services), through which he helps promote regulations and decisions that will facilitate fair competition in the telecommunications industry. Before joining US LEC in 1998, Mr. Cowell spent 11 years with Moore & Van Allen PLLC, a large Southeastern law firm, where he represented, among others, US LEC and Alcatel, primarily in corporate finance and merger and acquisition matters. Mr. Cowell is a graduate of Harvard Law School and Duke University.

Michael K. Robinson has been US LEC's executive vice president of finance and chief financial officer since July 1998. His responsibilities include financial controls, treasury, taxation, human resources, information systems, billing, facilities management and investor relations. Prior to joining US LEC, Mr. Robinson spent 10 years in various management positions with the telecommunications division of Alcatel. From 1996 to July 1998, Mr. Robinson was executive vice president and chief financial officer of Alcatel Data Networks, a developer and manufacturer of wide area network data switching equipment for carrier and enterprise solutions. Mr. Robinson was also responsible for the worldwide financial operations of the enterprise and data networking division of Alcatel. From 1989 to 1995, Mr. Robinson was vice president and chief financial officer of Alcatel Network Systems. Prior to joining Alcatel, Mr. Robinson held various management positions with Windward International and Siecor Corp. Mr. Robinson holds a masters degree in business administration from Wake Forest University.

ITEM 2. PROPERTIES

The Company's corporate headquarters are located at its principal office at Morrocroft III, 6801 Morrison Blvd., Charlotte, NC 28211. The Company leases all of its administrative and sales offices and its switch sites. The various leases expire during years through 2016. Most of these leases have renewal options. Additional office space and switch sites will be leased or otherwise acquired as the Company's operations and networks are expanded and as new networks are constructed.

ITEM 3. LEGAL PROCEEDINGS

US LEC is not currently a party to any material legal proceedings, other than proceedings, arbitrations, and any appeals thereof, related to reciprocal compensation, intercarrier access, wireless traffic and other amounts due from other carriers. For a description of these proceedings and developments that have occurred during the year ended December 31, 2002, see Note 6 to the consolidated financial statements appearing elsewhere in this report.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDER MATTERS

No matters were submitted to a vote of security holders during the quarter ended December 31, 2002.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's Class A common stock trades on The Nasdaq SmallCap Market under the symbol CLEC. As of March 21, 2003, US LEC Corp. had approximately 4,668 beneficial holders of its Class A common stock,. of that total, 155 were stockholders of record. To date, the Company has not paid cash dividends on its common stock. The Company currently intends to retain earnings to support operations and finance expansion and therefore does not anticipate paying cash dividends in the foreseeable future. In addition, the Company's senior credit facility, subordinated notes and the preferred stock agreements contain certain limitations on the payment of dividends.

The following table sets forth the high and low closing price information as reported by Nasdaq during the periods indicated since the Company's Class A Common Stock began trading publicly on April 24, 1998.

	Stock Price	
2001	**High**	**Low**
First Quarter	$9.06	$4.69
Second Quarter	$6.50	$2.28
Third Quarter	$4.01	$2.32
Fourth Quarter	$6.75	$2.73
2002	**High**	**Low**
First Quarter	$5.90	$3.10
Second Quarter	$3.50	$2.12
Third Quarter	$3.75	$1.56
Fourth Quarter	$2.69	$1.60

On December 31, 2002, the Company issued $5 million of subordinated notes and warrants to purchase shares of the Company's Class A common stock to a group of accredited investors that included the Company's founders, Richard T. Aab and Tansukh V. Ganatra. Mr. Aab currently serves as chairman of the Company and Mr. Ganatra is a director. Neither the notes, the warrants nor the shares of Class A common stock underlying the warrants were registered under the Securities Act of 1933, as amended (the "Securities Act"). These securities were offered and sold in reliance upon the exemption from registration provided by Section 4(2) of the Securities Act for transactions not involving any public offering. The Company's reliance upon this exemption was based upon the accredited status of the investors and the lack of any general solicitation in the offering.

ITEM 6. SELECTED FINANCIAL DATA

SELECTED FINANCIAL DATA

For the years ended December 31, 1998, 1999, 2000, 2001, and 2002
(In Thousands, Except Per Share Data and Operating Data, as noted below)

	1998	1999	2000	2001	2002
Statement of Operations:					
Revenue, Net	$ 84,716	$175,180	$ 114,964	$178,602	$ 250,363
Network Expenses	33,646	73,613	52,684	90,298	121,127
Selling, General and Administrative	25,020	48,375	80,684	114,898	112,878
Depreciation and Amortization	4,941	11,720	24,365	35,103	45,062
Provision for Doubtful Accounts related to WorldCom*	—	—	—	—	9,500
Loss on Resolution of Disputed Revenue*	—	—	55,345	—	—
Provision (Recovery) for Disputed Receivables*	—	—	40,000	(7,042)	—
Earnings (Loss) from Operations	21,109	41,472	(138,114)	(54,655)	(38,204)
Interest Income (Expense), Net	1,623	(2,046)	(3,005)	(8,699)	(7,688)
Earnings (Loss) before Income Taxes	22,732	39,426	(141,119)	(63,354)	(45,892)
Income Taxes Provision (Benefit)	9,305	15,617	(23,727)	—	—
Net Earnings (Loss)	13,427	23,809	(117,392)	(63,354)	(45,892)
Less: Dividends on Preferred Stock	—	—	8,758	12,810	13,596
Less: Accretion of Preferred Stock Issuance Cost	—	—	336	491	521
Net Earnings (Loss) Attributable to Common Stockholders	$ 13,427	$ 23,809	$(126,486)	$ (76,655)	$ (60,009)
Net Earnings (Loss) Per Share—Basic	$ 0.53	$ 0.87	$ (4.58)	$ (2.83)	$ (2.26)
Net Earnings (Loss) Per Share—Diluted	$ 0.52	$ 0.84	$ (4.58)	$ (2.83)	$ (2.26)
Weighted Average Shares Outstanding— Basic	25,295	27,431	27,618	27,108	26,546
Weighted Average Shares Outstanding—Diluted	25,804	28,411	27,618	27,108	26,546
Other Financial Data:					
Capital Expenditures	$ 47,292	$ 57,396	$ 109,740	$ 40,425	$ 32,029
Net Cash Flow Used in Operating Activities	(19,143)	(25,935)	(49,319)	(5,971)	(5,645)
Net Cash Flow Used in Investing Activities	(48,538)	(49,696)	(111,743)	(40,425)	(31,809)
Net Cash Flow Provided (Used) in Financing Activities	106,457	48,840	251,709	21,077	(17,333)
Operating Data:					
Number of States Served (including Washington, DC)	4	7	12	13	14
Number of Local Switches	11	16	23	26	26
Number of Customers	558	1,946	3,929	6,823	10,290
Number of Employees	253	460	816	892	911
Number of Sales and Sales Support Employees	98	180	330	365	367
Balance Sheet Data:					
Working Capital	$ 76,215	$113,109	$ 112,402	$ 59,972	$ 26,620
Accounts Receivable, Net	66,214	193,943	61,165	42,972	57,989
Current Assets	112,184	213,269	160,782	135,644	96,030
Property and Equipment, Net	56,219	102,002	188,052	188,436	178,810
Total Assets	170,203	320,100	373,159	333,313	285,314
Long-Term Debt (including current portion)	20,000	72,000	130,000	150,000	130,617
Series A Redeemable Convertible Preferred Stock	—	—	202,854	216,155	230,272
Total Stockholders' Equity (Deficiency)	112,975	138,870	(22,250)	(97,325)	(153,991)

* See Note 6 of the Company's Consolidated Financial Statements for the period ended December 31, 2002. Normal and recurring provisions for doubtful accounts are included in Selling, General and Administrative Expenses for all periods presented.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Except for the historical information contained herein, this report contains forward-looking statements, subject to uncertainties and risks, including the demand for US LEC's services, the ability of the Company to introduce additional products, the ability of the Company to successfully attract and retain personnel, competition in existing and potential additional markets, uncertainties regarding its dealings with ILECs and other telecommunications carriers and facilities providers, regulatory uncertainties, the possibility of adverse decisions related to reciprocal compensation and access charges owing to the Company, as well as the Company's ability to begin operations in additional markets. These and other applicable risks are summarized in the "Forward-Looking Statements and Risk Factors" section and elsewhere in this Annual Report on Form 10-K, and in other reports, which are on file with the Securities and Exchange Commission.

The following discussion and analysis should be read in conjunction with the "Selected Consolidated Financial Data" on page 22 of this report and the Company's consolidated financial statements and related notes thereto appearing elsewhere in this report.

Company Overview

US LEC Corp. ("US LEC" or the "Company) is a Charlotte, NC-based telecommunications carrier providing voice, data and Internet services to over 10,000 mid-to-large-sized business customers throughout the southeastern and mid-Atlantic United States. As of December 31, 2002, the US LEC network consisted of 26 Lucent 5ESS® AnyMedia™ digital switches, 26 Lucent CBX500 Asynchronous Transfer Mode ATM data switches, five Juniper Networks® M20™ Internet Gateway routers and an Alcatel MegaHub® 600ES tandem switch. The US LEC local service area includes Alabama, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, New Jersey, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia and the District of Columbia. US LEC also offers selected voice services in Arkansas, California, Connecticut, Indiana, Massachusetts, Montana, Nevada, New York, Ohio, Texas and Wisconsin, in addition to providing data services in these and other states. The Company primarily serves telecommunications-intensive business customers including the automotive, construction, education, financial, government, healthcare, hospitality, Internet service providers, other telecommunication carriers, professional/legal, real estate, retail and transportation sectors.

US LEC's revenue is comprised of two primary components: (1) fees paid by end customers for local, long distance, data and Internet services, and (2) carrier charges primarily including access and reciprocal compensation. End customer revenue includes local, long distance, data and Internet services and is comprised of monthly recurring charges, usage charges, and initial non-recurring charges. Monthly recurring charges include the fees paid by customers for facilities in service and additional features on those facilities. Usage charges consist of usage-sensitive fees paid for calls made. Initial non-recurring charges consist primarily of installation charges. Access charges are comprised of charges paid primarily by inter-exchange carriers ("IXCs") for the origination and termination of inter-exchange toll and toll-free calls and reciprocal compensation. The Company does not resell any incumbent local exchange carrier ("ILEC") dial tone services. Reciprocal compensation arises when a local exchange carrier completes a call that originated on another local exchange carrier's network. Reciprocal compensation rates are fixed by an interconnection agreement executed between those carriers or mandated by the FCC. The following table provides a breakdown of the two primary components of net revenue:

	2002	2001	2000
End Customer Revenue	59%	53%	47%
Carrier Charges Including Access and Reciprocal Compensation	41%	47%	53%

US LEC was founded to establish a company that would provide a wide array of telecommunications services to its customers. US LEC has deployed a significant regional network, and as of December 2002 has active switches in 26 sites, serving over 10,000 medium to large size business customers. Management believes this customer base, achieved in less than six years, is indicative of the market's acceptance of US LEC's strategy and service offerings. Management expects the Company's end customer revenue to continue to increase and carrier access revenue to continue to decrease as percentages of total revenue in future periods. This results from US LEC continuing to expand its customer base, and as carrier access rates decline due primarily from rate reductions in new agreements entered into by the Company with ILECs and IXCs and to regulatory and legislative actions.

In order to interconnect its switches to the network of the local incumbent phone company and to exchange traffic with it, the Company executes interconnection agreements with the incumbent carriers. The terms and conditions of the interconnection agreements are effected by the Telecom Act, decisions of state and federal regulatory bodies and negotiations with the carriers involved. The Company may voluntarily enter into such an agreement, petition a state regulatory commission to arbitrate issues that can not be resolved by negotiation or opt into agreements executed by the incumbent and other competitive carriers. The Company has signed or opted into interconnection agreements with all of the incumbent local carriers where it offers services requiring such agreements (See "Business—Forward Looking Statements and Risk Factors—Interconnection Agreements, and - Disputed Revenues").

Results of Operations

Comparison of Year Ended December 31, 2002 to Year Ended December 31, 2001

Net revenue increased to $250.4 million for the year ended December 31, 2002, from $178.6 million in 2001. The significant increase in revenue resulted from an increase in the total number of customers in existing markets and an increase in telecommunications traffic on the Company's network. In 2002, the Company's end customer revenue increased to $148.9 million, or 59% of total revenue from $93.8 million, or 53% of total revenue in 2001. End customer revenue is generated from local, long distance and data services.

The Company recorded a significant charge relating to disputed receivables in the fourth quarter of 2000. The $52.0 million provision is netted on the Company's consolidated statement of operations against a $12.0 million reduction in commissions payable on those receivables, resulting in the $40.0 million provision on the Company's consolidated statement of operations. Management believed that this charge was necessary due to the uncertainty related to current regulatory proceedings related to reciprocal compensation and other access charges and the continued refusal by ILECs, principally BellSouth, to pay amounts believed by the Company to be owed to it under applicable interconnection agreements and due to Sprint's failure to pay US LEC's access charges. The Company resolved its disputes with both BellSouth and Sprint during 2001. Included in the 2001 consolidated statements of operations is an amount approximating $7.0 million, representing a net recovery of amounts previously recorded as reserves for disputed receivables and certain other related accruals (see Disputed Revenue below).

Network expenses are comprised primarily of leased transport, facility installation, and usage charges. Network expenses increased to $121.1 million, or 48% of net revenue for 2002 from $90.3 million, or 50% of net revenue, for 2001. This increase in network expenses was primarily a result of the increase in the size of US LEC's network, an increase in customers and usage by its customers, as well as a shift to higher network expense for end customer revenue.

Selling, general and administrative expenses for the year ended December 31, 2002 decreased to $112.9 million, or 45% of revenue, compared to $114.9 million, or 64% of revenue, for the year ended December 31, 2001, exclusive of the $9.5 million provision for doubtful accounts related to WorldCom and the $7.0 million recovery for disputed receivables in 2002 and 2001, respectively. These expenses are primarily comprised of costs associated with developing and expanding the infrastructure of the Company as it expands into new markets and adds new products. Such expenses are associated with personnel, sales and marketing, occupancy, bad debt, administration and billing, as well as legal fees associated with litigation. The decrease in selling, general and administrative expenses as a percentage of revenue in 2002 was primarily due to expense control, an improvement in back office efficiencies and growth in revenue.

Depreciation and amortization for 2002 increased to $45.1 million from $35.1 million in 2001 primarily due to the increase in depreciable assets in service related to US LEC's network expansion.

Interest income for 2002 decreased to $0.9 million from $3.2 million in 2001. The decrease in interest income in 2002 was primarily due to a decline in cash available for investing and declining rates of return on invested funds.

Interest expense for 2002 decreased to $8.6 million from $11.9 million in 2001. This decrease in interest expense was primarily due to a decrease in the amounts borrowed resulting from over $22.0 million in principal payments made under the Company's senior credit facility in addition to declining interest rates.

For the years ended December 31, 2002 and 2001 the Company did not record an income tax benefit. The Company has provided a full valuation allowance against deferred assets resulting from net operating losses, as management cannot predict, based on the weight of available evidence, that it is more likely than not that such assets will be ultimately realized.

Net loss for 2002 amounted to $45.9 million, compared to a net loss of $63.4 million for 2001. Dividends paid in kind and accrued on preferred stock for the year ended December 31, 2002 and 2001 amounted to $13.6 million and $12.8 million, respectively (See Note 5 of the Company's consolidated financial statements). The accretion of preferred stock issuance cost was $0.5 million for each of the years ended December 31, 2002 and 2001.

As a result of the foregoing, net loss attributable to common stockholders for the year ended December 31, 2002 amounted to $60.0 million or $2.26 per diluted share as compared to $76.7 million, or $2.83 per diluted share for 2001. The decrease in net loss and net loss per share is attributed to the factors discussed above.

Comparison of Year Ended December 31, 2001 to Year Ended December 31, 2000

Net revenue increased to $178.6 million for the year ended December 31, 2001, from $115.0 million in 2000. The significant increase in revenue resulted from an increase in the total number of customers in existing markets and an increase in telecommunications traffic on its network. In 2001, the Company's end customer revenue increased to $93.8 million or 53% of total revenue from $54.2 million or 47% of total revenue in 2000.

The loss on the resolution of disputed revenue in 2000 was a result of an order issued by the North Carolina utilities commission on March 31, 2000 (the "March 31 NCUC Order") that relieved BellSouth from paying reciprocal compensation to US LEC for any minutes of use attributable to the network operated by Metacomm, a customer of BellSouth and US LEC, or any similar network. As a result of this order, the Company recorded a pre-tax non-recurring non-cash charge of $55.3 million in the first quarter of 2000. This charge was composed of the write-off of approximately $153.0 million in receivables related to reciprocal compensation revenue offset by a previously established allowance of $39.0 million, and a reduction of approximately $59.0 million in reciprocal compensation commissions payable to Metacomm.

The Company recorded a significant charge relating to disputed receivables in the fourth quarter of 2000. The $52.0 million provision is netted on the Company's consolidated statement of operations against a $12.0 million reduction in commissions payable on those receivables, resulting in the $40.0 million provision on the Company's consolidated statement of operations. Management believed that this charge was necessary due to the uncertainty related to current regulatory proceedings related to reciprocal compensation and other access charges and the continued refusal by ILECs, principally BellSouth, to pay amounts believed by the Company to be owed to it under applicable interconnection agreements and due to Sprint's failure to pay US LEC's access charges. The Company resolved its disputes with both BellSouth and Sprint during 2001. Included in the consolidated statements of operations is an amount approximating $7.0 million, representing a net recovery of amounts previously recorded as reserves for disputed receivables and certain other related accruals (see Disputed Revenue below).

Network expenses are comprised primarily of leased transport, facility installation, and usage charges. Network expenses increased to $90.3 million, or 50% of revenue for 2001 from $52.7 million, or 45% of revenue, for 2000. This increase in network expenses was primarily a result of the increase in the size of US LEC's network, an increase in customers and usage by its customers, as well as a shift to lower margin end customer revenue.

Selling, general and administrative expenses for the year ended December 31, 2001 increased to $114.9 million, or 64% of revenue, compared to $80.7 million, or 70% of revenue, for the year ended December 31, 2000. This increase was primarily a result of costs associated with developing and expanding the infrastructure of the Company as it expands into new markets and adds products, such as expenses associated with personnel, sales and marketing, occupancy, administration and billing, as well as legal expenses associated with litigation. The decrease in selling, general and administrative expenses as a percentage of revenue in 2001 was primarily due to expense control, an improvement in back office efficiencies and growth in end customer revenue.

Depreciation and amortization for 2001 increased to $35.1 million from $24.4 million in 2000 primarily due to the increase in depreciable assets in service related to US LEC's network expansion.

Interest income for 2001 decreased to $3.2 million from $4.8 million in 2000. The decrease in interest income in 2001 was primarily due to a decline in cash available for investing and declining rates of return on invested funds.

Interest expense for 2001 increased to $11.9 million from $7.8 million in 2000. This increase in interest expense was primarily due to increased borrowings under the Company's senior secured credit facility partially offset by declining interest rates.

For the year ended December 31, 2001, the Company did not record an income tax expense or benefit, compared to a $23.7 million income tax benefit in 2000. In 2001, the income tax benefit, primarily created from operating losses, was offset by increases in the tax valuation allowance. The $23.7 million benefit for the year ended December 31, 2000 is net of an increase of $35.7 million in the valuation allowance against deferred tax assets relating to the anticipated use of federal and state net operating losses.

Net loss for 2001 amounted to $63.4 million, compared to a net loss of $117.4 million for 2000. Dividends paid in kind and accrued on preferred stock for the year ended December 31, 2001 and 2000 amounted to $12.8 million and $8.8 million, respectively (See Note 5 of the Company's consolidated financial statements). The accretion of preferred stock issuance cost was $0.5 million and $0.3 million for the years ended December 31, 2001 and 2000, respectively.

As a result of the foregoing, net loss attributable to common stockholders for the year ended December 31, 2001 amounted to $76.7 million or ($2.83) per diluted share as compared to $126.5 million, or ($4.58) per diluted share for 2000. The decrease in net loss and net loss per share is attributed to the factors discussed above.

Liquidity and Capital Resources

The Company completed the build-out of its announced network and switch locations during the year ended December 31, 2001. Fiscal 2002 was the first year that all 26 switching centers were operational for the entire year. The Company has experienced net losses for the past three fiscal years, although these losses have decreased annually, and has a total stockholders' deficiency of $154.0 million at December 31, 2002. Primary funding for the completion of the build-out and for supporting company operations during these recent years came from borrowings under the Company's senior secured credit facility and from the proceeds received from the issuance of Series A Mandatorily Redeemable Preferred Stock. The Company began the required principal payments on the senior secured credit facility during 2002, and is fully borrowed against this facility. The amount outstanding under the senior secured credit facility at December 31, 2002 was $127.9 million. Also during this period, the Company has focused its operating strategy on growing end customer revenue, customer retention, improving the efficiency of its network operations and in controlling selling and administrative costs and capital expenditures. Recent quarterly results have shown increases in total revenue, end customer revenue, the number of customers and other operating metrics. Although the magnitude of capital expenditures required has declined since the network build-out was completed, there will still be substantial investment required as new customers are added to the Company's network. In connection with its quarterly filing for the period ended September 30, 2002, Company management disclosed that it believed that cash on hand would be sufficient to fund operating, investing and financing activities into the third quarter of 2003. It also disclosed that is was aggressively pursuing other options to obtain additional financing, and improve liquidity to fund operations beyond September 30, 2003. During the quarter ended December 31, 2002, the Company completed an amendment of its senior credit facility and, as a condition to complete this amendment, issued subordinated notes with warrants in the amount of $5.0 million. The credit facility amendment, further described below, provided for the deferral of previously required principal payments to later years, and revised the Company's covenant requirements based on a business plan supplied to its senior lenders. Company management believes its operating results will be sufficient, in conjunction with the deferral of principal payments resulting from the amended facility, and in consideration of the cash on hand at December 31, 2002 of $25.7 million, to meet its operating, investing and financing obligations for a period at least through December 31, 2003 as they come due. Also in the opinion of management, the Company will be in compliance with its covenant requirements.

On December 31, 2002, the Company amended its senior secured credit facility. As a condition to amending the senior secured credit facility, the Company's senior lenders required an investment of $5.0 million in the Company. Therefore, concurrent with amending the senior secured credit facility, the Company received gross proceeds of $5.0 million through the issuance of 11% subordinated notes with a face amount of $5.0 million (the "Subordinated Notes") and warrants to purchase shares of the Company's common stock (the "2002 Warrants"). The $5.0 million was invested by a group of private investors that included the Company's founders, Richard T. Aab and Tansukh V. Ganatra. Mr. Aab currently serves as Chairman of the Company and Mr. Ganatra serves as a director.

As amended, the senior secured credit facility is comprised of a $102.9 million term loan and a $25.0 million revolving credit facility. The Company made an $8.0 million principal payment on the term loan in connection with the amendment, reducing the outstanding balance from $110.9 million to $102.9 million. The interest rate for the facility is a floating rate based, at the Company's option, on a base rate (as defined in the loan agreement) or the London Interbank Offered Rate, plus a specified margin. Advances under the credit agreement as of December 31, 2002 bear interest at an average annual rate of approximately 5.75%. The facility is secured by a security interest in substantially all of the Company's assets.

In amending the senior secured credit facility, the Company deferred $30.0 million of term loan principal payments from 2003 and 2004 to 2005 and 2006; deferred repayment of the $25.0 million outstanding under the revolving facility from 2005 to 2006; agreed to pay additional interest on the deferred portion of the term loan amounts at an annual rate of 10%, payable upon the maturity of the loan in December 2006, and agreed to revised financial covenants.

As amended, in addition to regular scheduled quarterly principal payments, the Company is required to make certain mandatory prepayments of principal equal to a portion of the interest paid to the Subordinated Note holders. These mandatory prepayments are scheduled to be $0.3 million in 2003, 2004, 2005 and 2006. There are no other regular scheduled principal payments due during 2003, $0.5 million in principal payments are due in March and June 2004, $3.2 million is due in September 2004, $6.2 million is due in December 2004, $11.4 million is payable in each quarter of 2005 and the first three quarters of 2006, and a final principal payment of $11.1 million is due when the term loan matures in December 2006.

The revised financial covenants were designed to conform to the business plan provided by the Company to its senior lenders in connection with the amendment. The covenants include: achievement of minimum levels of earnings before interest, taxes, depreciation, amortization and credit restructuring costs; maintenance of a minimum specified gross margin percentage (as defined), limits on the amount of capital expenditures; maintenance of minimum levels of unrestricted cash; and beginning in March 2005, maintenance of specified total leverage, cash interest coverage and minimum fixed charge coverage ratios. Measurements of the revised covenants will commence in 2003. Management believes that the Company will be in compliance with all financial covenants for a period at least through December 2003. The operating results reflected in the business plan are dependent on the Company meeting targets for new customers, customer retention, customer usage, billing rates, gross margins and selling, general, and administrative costs and as a result involve some degree of uncertainty. Should any of these assumptions not be achieved for a particular period, it is possible that a financial covenant will not be met for the period through December 2003. If a waiver or amendment of the financial covenant cannot not be obtained, the lenders would have the right under the credit agreement to certain remedies including acceleration of debt repayment.

The $5.0 million in gross proceeds received on December 31, 2002 was allocated, based on the approximate relative fair values, $2.7 million to the Subordinated Notes and $2.3 million to the 2002 Warrants. The Subordinated Notes are included in long-term debt and the 2002 Warrants are included in additional paid-in-capital in the accompanying consolidated balance sheet as of December 31, 2002. The Subordinated Notes bear interest at an annual rate of 11% payable monthly, have a five-year term and are subordinated to the senior credit facility. The discount on the Subordinated Notes will be amortized over the term of the notes. The Subordinated Note holders received warrants to purchase 1,737 and 895 shares of the Company's common stock at an exercise price of $1.90 and $2.06 per share, respectively. The 2002 Warrants are exercisable immediately and expire upon the earlier of 10 years or five years from the repayment in full of the Subordinated Notes. The Company granted the 2002 Warrant holders demand and piggyback registration rights with respect to the common stock underlying the 2002 Warrants.

Cash used in operating activities was approximately $5.6 million in 2002 compared to $6.0 million in 2001. The decrease in cash used in operating activities was primarily due to a reduction of cash used from operating activities prior to changes in working capital of $41.7 million, offset by an increase in cash used of $41.3 million for working capital purposes, primarily resulting from an increase in accounts receivable of $15.0 million from the prior year. The Company received payment of approximately $50.0 million from BellSouth and Sprint during 2001 as a result of its settlements with both companies over disputed revenues (see Disputed Revenue below).

Cash used in investing activities decreased to $31.8 million in 2002 from $40.4 million in 2001. The investing activities are related to purchases of switching and related telecommunications equipment, office equipment and leasehold improvements. Future annual capital expenditures are expected to be consistent with those in 2002.

Cash used by financing activities was $17.3 million in 2002 compared to $21.1 million cash provided for 2001 due to the increase in repayments, net of borrowings, under the Company's amended senior secured credit facility in 2002.

The restricted cash balance of $1.1 million and $1.3 million as of December 31, 2002 and 2001, respectively, serves as collateral for letters of credit related to certain office leases. Restricted cash is utilized to secure the Company's performance of obligations such as letters of credit to support leases or deposits in restricted use accounts.

The following table provides a summary of the Company's contractual obligations and commercial commitments. Additional detail about these items is included in the notes to the consolidated financial statements.

	Dollars in millions				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Contractual Obligations					
Long-term debt (1)	$127.9	$ 0.3	$127.6	$—	$—
Subordinated Notes (2)	5.0	—	—	5.0	—
Operating leases	49.9	7.4	7.2	6.5	28.8
Total contractual cash obligations	$182.8	$ 7.7	$134.8	$11.5	$28.8

(1) Interest on long-term bank debt is charged using a floating rate based, at the Company's option, on a base rate (as defined in the loan agreement) or the London Interbank Offered Rate, plus a specified margin. The Company will also accrue additional interest on the deferred portion of the term loan amounts at an annual rate of 10%, payable upon the maturity of the loan in December 2006.

(2) Interest is payable monthly on the $5.0 million face value of the Subordinated Notes at an annual rate of 11%. In addition, the discount on the Subordinated Notes, determined based upon the relative fair values of the notes and related warrants, totaled $2.3 million. This amount will be amortized to the statement of operations until the maturity date of the Subordinated Notes.

Disputed Revenues

The deregulation of the telecommunications industry, the implementation of the Telecom Act enacted on February 8, 1996 and the distress of many carriers in the wake of the downturn in the telecommunications industry have involved numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state and federal regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company. These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, access rates applicable to different categories of traffic such as traffic originating from or terminating to cellular or wireless users and the jurisdiction of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations and proceedings over these and other material issues. The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of its operations. Revenue recognized and amounts recorded as allowances for doubtful accounts in the accompanying financial statements have been determined considering the impact, if any, of the items described below.

Reciprocal Compensation—On April 27, 2001, the FCC released an Order on Remand and Report and Order (the "Remand Order") addressing inter-carrier compensation for traffic terminated to ISPs. The interpretation and enforcement of the Remand Order will likely be the most important factor in the Company's efforts to collect reciprocal compensation for ISP-bound traffic in the future. In the Remand Order, the FCC addressed a number of important issues, including the rules under which carriers are to compensate each other for traffic terminated to ISPs and the rates applicable for ISP-bound traffic as well as traffic bound to other customers.

While the Remand Order provides greater certainty about the Company's right to bill for traffic terminated to ISPs, the effect of the Remand Order on the Company will depend on how it is interpreted and enforced. In particular, there are uncertainties as to whether the Remand Order has any effect on the Company's pending arbitral, state regulatory commission and judicial proceedings seeking to collect compensation for traffic previously terminated to ISPs; whether certain provisions of the Remand Order will be applied state-by-state, market-by-market and/or carrier-by-carrier; whether the limitations on growth of ISP traffic in the Remand Order will survive legal challenge; and whether the incumbent carrier will efficiently trigger the rate reductions and other limitations set forth in the Remand Order.

On May 3, 2002, the U.S. Court of Appeals for the District of Columbia (the "D.C. Circuit") rejected the FCC's legal analysis in the Remand Order and again remanded the order to the FCC for further review (the "Second Remand"), but the D.C. Circuit did not vacate the Remand Order. As such, the ISP compensation structure established by the FCC in the Remand Order remains in effect. It is unclear at this time whether, how or when the FCC will respond to the Second Remand, how the Second Remand affects pending disputes over reciprocal compensation for ISP traffic, how the Remand Order will be interpreted or whether affected parties will undertake new challenges to the ISP compensation structure established by the Remand Order.

If the Remand Order or the Second Remand were to be interpreted in a manner adverse to the Company on all or any of the issues, or if the Remand Order is modified as a result of the Second Remand or other pending or new legal challenges, it could have a material adverse effect on the Company's future operations. For further discussion of the Remand Order, see "Business—Regulation".

On October 3, 2001 the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which the Company and BellSouth resolved outstanding reciprocal compensation receivables in the various states in which both of us operate and other past payments. BellSouth agreed to pay US LEC approximately $31.0 million, in addition to approximately $10.0 million it paid in August 2001, to resolve those issues for periods prior to the effective date of the Remand Order. The Settlement Agreement imposed on the parties certain obligations regarding the payment of reciprocal compensation in the future. The Settlement Agreement also provides that the payments made for periods prior to the effective date of the Remand Order are not subject to adjustment as a result of subsequent changes in the Remand Order.

In September 2001, the Company filed a proceeding with the Virginia State Corporation Commission ("VSCC") and the FCC seeking to collect reciprocal compensation from Verizon payable for traffic bound for ISPs as well as other customers. The VSCC declined jurisdiction over the dispute. In January 2002, the FCC accepted jurisdiction over the dispute. Prior to the Company's filing a complaint against Verizon at the FCC, and in a separate, but related, case, the FCC held that the contract with Verizon (that the Company had adopted) did not obligate the parties to pay reciprocal compensation for traffic bound for ISPs. That decision is on appeal. In June 2002, Verizon filed a complaint against the Company in the United States District Court for the Eastern District of Virginia seeking a declaratory ruling that Verizon is not obligated to pay the Company reciprocal compensation for traffic bound for ISPs under the agreement adopted by the Company. The Company moved to dismiss Verizon's complaint based on a number of factors; the Court took the Company's motion under advisement and directed the Company to initiate a proceeding against Verizon at the FCC. On September 5, 2002, the Company filed a Formal Complaint with the FCC's Enforcement Bureau seeking to collect reciprocal compensation from Verizon for traffic bound for ISPs. Verizon answered, denying liability. Pending the outcome of the appeal in the related case, the FCC converted the Company's case against Verizon into an informal complaint and has placed it on an administrative hold. In light of these developments, as well as the Second Remand, the Company cannot predict when this dispute will be resolved or whether the Company will ultimately be successful.

Disputed Access Revenues—A number of IXCs have refused to pay access charges to CLECs, including the Company, alleging that the access charges exceed the rates charged by the ILECs, as well as disputing the rates applicable to different categories of traffic and the jurisdiction of traffic for compensation purposes. Currently there are a number of court cases, regulatory proceedings at the FCC and legislative efforts involving such challenges. The Company cannot predict the outcome of these cases, regulatory proceedings and legislative efforts or their impact on access rates.

On April 27, 2001, the FCC released its Seventh Report and Order and Further Notice of Proposed Rulemaking (the "Access Order") in which it established a benchmark rate at which a CLECs interstate access charges will be presumed to be reasonable and which CLECs may impose on IXCs by tariff. The Access Order addresses a number of issues important to how CLECs charge IXCs for originating and terminating interstate toll and toll free traffic.

The Access Order should provide certainty as to the Company's right to bill IXCs for interstate access at rates at or below the FCC benchmark even though above those tariffed by the ILECs. Notwithstanding the apparent certainty created by the Access Order, its effect on the Company will depend on how the Access Order is interpreted and enforced and the outcome of appeals currently pending. If the Access Order is interpreted or enforced in a manner adverse to the Company as it relates to periods prior to the effective date, such result could have a material adverse effect on the Company. For a more complete description of the Access Order, please see "Business—Regulation".

On May 30, 2001, the FCC issued a decision in AT&T Corp. v. Business Telecom Inc. (the "BTI Decision"), in which the FCC determined that the interstate access rates charged by Business Telecom, Inc. ("BTI") were not just and reasonable. The FCC determined that just and reasonable rates for BTI were properly based upon the lowest band of rates charged by the National Exchange Carriers Association ("NECA"). The FCC based this holding on the limited evidence before it, tending to show that BTIs operations were similar to those of small, urban ILECs, many of whom charge the lowest band NECA rates. Appeals of the BTI Decision were subsequently withdrawn. As with the Access Order described above, the BTI Decision's effect on the Company will depend on how the order is interpreted. If the BTI Decision is interpreted in a manner adverse to the Company, such result could have a material adverse effect on the Company.

By settlement dated October 5, 2001, Sprint and the Company resolved their litigated dispute over access charges. Sprint paid the Company approximately $8.0 million, in addition to approximately $1.5 million it paid in the four months preceding the settlement, in payment of past due invoices for periods through July 2001.

Due to the federal bankruptcy filing by WorldCom, during the quarter ended June 30, 2002, the Company established an additional provision of $9.5 million for doubtful accounts for the remaining outstanding receivables owed to the Company by WorldCom. The Company is pursuing its claim for the payment of all outstanding charges in the WorldCom bankruptcy proceeding, but is fully reserved for the amount due from WorldCom for all pre-petition amounts.

On September 18, 2002, US LEC filed a Petition for Declaratory Ruling with the FCC requesting that the FCC reaffirm its prior positions that access charges can be collected by local exchange carriers in connection with calls originating or terminating on the networks of wireless carriers. A number of different carriers have filed comments in support of, and in opposition to, US LEC's petition. In addition ITC^DeltaCom Communications, Inc. ("ITC") has filed a lawsuit against the Company alleging that in an effort to collect access charges from ITC for originating wireless traffic destined for ITCs toll-free customer, US LEC blocked certain signaling data for calls originated on the networks of US LEC's wireless carrier customers that would allow the call to be identified as a wireless call. ITC's lawsuit alleges claims based on a number of different legal theories. US LEC, through counsel, has investigated ITC's allegations, and has discovered no evidence to support ITC's claims. US LEC has denied ITC's allegation and asserted a counterclaim against ITC to recover outstanding access charges owed by ITC. The Company anticipates dispositive motions will be filed shortly as the Company seeks early resolution of the case. In addition to the lawsuit filed in federal court, ITC also filed an Informal Complaint at the FCC challenging US LEC's right to recover access charges on calls originating from wireless carriers. The informal complaint was closed without the FCC taking any action. The Company also received a separate request for information from the Enforcement Bureau of the FCC concerning the Company's billing for wireless traffic and its methods of billing. The Company intends to respond to the FCC's requests. Further, the Company will discuss with the FCC its belief that no additional proceedings are warranted by the agency beyond those already pending on the issue of terminating calls originating on the networks of wireless carriers, including the proceeding commenced by US LEC requesting guidance to the industry on the issue. If the FCC does not reaffirm its prior guidance, the inability of US LEC to recover access charges from IXCs for traffic originating on the networks of wireless carrier customers could have a material negative impact on US LEC's results of operations.

In light of the general conditions prevailing in the telecommunications industry, there is a risk of further delinquencies, nonpayment or bankruptcies by other telecommunications carriers that owe outstanding amounts derived from access and facility revenues billed by the Company. Such events, in the aggregate, could have an adverse effect on the Company's performance in future periods. The Company is unable to predict such events at this time.

Legislation—Periodically, legislation has been introduced in the U.S. House of Representatives or the U.S. Senate to alter or amend the Telecom Act. It is the Telecom Act which opened the local telephone markets for competition and outlines many of the ground rules pursuant to which the ILECs and the CLECs operate with respect to each other. The Company anticipates that additional efforts will be made to alter or amend the Telecom Act. The Company cannot predict whether any particular piece of legislation will become law and how the Telecom Act might be modified. The passage of legislation amending the Telecom Act could have a material adverse effect on the Company and its future financial results.

Interconnection Agreements with ILECs—The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has installed a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, it will be required to negotiate extension or replacement agreements. The Company recently concluded interconnection arbitrations with Verizon in order to obtain new interconnection agreements on terms acceptable to the Company and is awaiting results from those arbitrations from several PUCs. There can be no assurance that the Company will successfully negotiate, successfully arbitrate or otherwise obtain such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company.

Interconnection with Other Carriers—The Company anticipates that as its interconnections with various carriers increase, the issue of seeking compensation for the termination or origination of traffic whether by reciprocal arrangements, access charges or other charges will become increasingly complex. The Company does not anticipate that it will be cost effective to negotiate agreements with every carrier with which the Company exchanges originating and/or terminating traffic. The Company will make a case-by-case analysis of the cost effectiveness of committing resources to these interconnection agreements or otherwise billing and paying such carriers.

Critical Accounting Policies and Estimates

Revenue Recognition—The Company recognizes revenue on telecommunications and enhanced communications services in the period that the service is provided. Revenue is recognized when earned based upon the following specific criteria: (1) persuasive evidence of arrangement exists (2) services have been rendered (3) seller's price to the buyer is fixed or determinable and (4) collectibility is reasonably assured.

US LEC's revenue is comprised of two primary components: (1) fees paid by end customers for local, long distance, data and Internet services, and (2) carrier charges including access and reciprocal compensation. End customer revenue includes local, long distance, data and Internet services and is comprised of monthly recurring charges, usage charges, and initial non-recurring charges. Monthly recurring charges include the fees paid by customers for facilities in service and additional features on those facilities. Usage charges consist of usage-sensitive fees paid for calls made. Initial non-recurring charges consist primarily of installation charges. Access charges are comprised of charges paid primarily by IXCs for the origination and termination of inter-exchange toll and toll-free calls and reciprocal compensation. The Company does not resell any ILEC dial tone services. Reciprocal compensation arises when a local exchange carrier completes a call that originated on another local exchange carrier's network. Reciprocal compensation that is earned as revenue from other local exchange carriers represents compensation for local telecommunications traffic terminated on our network that originates on another carrier's network.

If a significant disputed revenue situation exists, revenue is recorded at amounts at which management believes collectibility is reasonably assured.

The Company defers installation revenue from contracts with end customers and other carriers net of certain incentives. This deferred revenue is being amortized over the period of expected benefit of these costs, which is the average initial term of the related contract.

Carrier revenues are recorded net of amounts due to external parties under each respective telecommunications service contract. Early termination fees are recognized when paid and revenue related to billings in advance of providing service is deferred and recognized when earned.

Network Expenses—Network expenses are comprised primarily of two types of charges: leased transport charges which comprise approximately 80% of the Company's network expenses and usage sensitive charges which comprise approximately 20% of the Company's network expenses. The Company's leased transport charges are the lease payments incurred by US LEC for the transmission facilities used to connect the Company's customers to the Company owned switch that services that customer and to connect to the ILEC and other carrier networks. US LEC, as part of its "smart-build" strategy, does not currently own any fiber or copper transport facilities. These facilities are leased from various providers including, in many cases, the ILEC. Network expenses include management's estimate of charges for direct access lines, facility charges, outgoing and incoming minutes, reciprocal compensation and other costs of revenue for a given period for which bills have not yet been received by the Company. Management's estimate is developed from the number of lines and facilities in service, minutes of use and contractual rates charged by each respective service provider. Subsequent adjustments to this estimate may result when actual costs are billed by the service provider to the Company. However, management does not believe such adjustments will be material to the Company's financial statements. The Company has to date been successful in negotiating lease agreements which generally match in the aggregate the duration of its customer contracts, thereby allowing the Company to mitigate the risk of incurring charges associated with transmission facilities that are not being utilized by customers. Usage sensitive charges are primarily comprised of usage charges associated with the Company's off-net toll, toll-free services, access charges and reciprocal compensation owed to other carriers. Also included in network expense are the amortization of deferred customer and network installation costs, which are discussed in more detail below.

Provisions for Doubtful Accounts—The Company maintains an allowance for doubtful accounts for estimated losses resulting from customers' or carriers' failure to make payments on amounts due to the Company. These estimates are based on a number of factors including 1) historical experience, 2) aging of trade accounts receivable, and 3) specific information obtained by the Company on the financial condition and current credit worthiness of customers or carriers.

Deferred Customer and Network Installation Costs—The Company incurs and capitalizes certain costs in connection with the required expansión of its telecommunications network infrastructure to provide service to new customers. These costs are comprised of payments for equipment and services provided by external parties in connecting the telecommunication systems of new customers to the Company's telecommunication platform as well as expenditures for expanding the network when customer growth requires capacity enhancements. These two types of costs are referred to as customer installation costs and network installation costs. Customer installation costs represent incremental direct costs to enhance the Company's telecommunications network to allow the Company to provide services to new customers under contract. These costs result directly from entering into a new customer contract and would not have been incurred by the Company had a new contract not been entered into. These costs are amortized over the average initial term of open contracts, which is currently 30 months.

Network installation costs are paid to local exchange carriers and IXCs for installing circuits and trunks to insure adequate capacity on the Company's network to serve existing and new customers. These costs are paid to external parties for the installation of circuits and trunks required in order to provide and market services to new customers. Network installation costs are amortized over 60 months, the expected useful life of the circuits and trunks that are installed.

Impairment of Long-Lived Assets—The Company reviews the carrying value of its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. Measurement of any impairment would include a comparison of estimated undiscounted future operating cash flows anticipated to be generated during the remaining life of the assets with their net carrying value. An impairment loss would be recognized as the amount by which the carrying value of the assets exceeds their fair value.

Effect of Recently Issued Accounting Pronouncements

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities by requiring that entities recognize all derivatives as either assets or liabilities at fair market value on the balance sheet. The adoption of SFAS No. 133 did not have a material effect on its results of operations as it does not currently hold any derivative instruments or engage in hedging activities.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS 121, "Accounting for Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", but retains many of its fundamental provisions. SFAS 144 also supercedes the accounting and reporting provisions of APB Opinion 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." This statement retains the requirement to report discontinued operations separately from continuing operations and expands the scope of transactions that qualify as discontinued operations. SFAS No. 144 was effective for the Company for financial statements issued for the fiscal year beginning January 1, 2002. The adoption of SFAS No. 144 did not have a material effect on the Company's results of operations.

In April 2002, SFAS No. 145 "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB No. 13, and Technical Corrections" was issued. SFAS No. 145, among other things, eliminates FASB Statement No. 4 "Reporting Gains and Losses from Extinguishment of Debt" which required gains and losses from debt extinguishments to be aggregated and, if material, classified as an extraordinary item net of associated income tax effects, and also eliminates the exception to applying Accounting Principles Board (APB) Opinion No. 30. As such, gains and losses from debt extinguishments should be classified as extraordinary items only if they meet certain criteria in APB Opinion No. 30. Such criteria distinguishes transactions that are part of an entity's recurring operations from those that are unusual or infrequent or that meet the criteria of APB Opinion No. 30 for classification as an extraordinary item. The provisions of SFAS No. 145 related to the rescission of SFAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. The application of such provisions of SFAS No. 145 is not expected to have a material effect on the Company's results of operations.

In June 2002, SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" was issued and is effective for such activities initiated after December 31, 2002. SFAS No. 146 specifies, among other things, the financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3 "Liability Recognition for Certain Employee Benefits and Other Costs to Exit an Activity, including Certain Costs Incurred in a Restructuring." The adoption of SFAS No. 146 is not expected to significantly impact the Company's financial statements or future results of operations.

In November 2002, FASB Interpretation No. 45 ("FIN 45") "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" was issued which, among other things, expands guarantor financial statement disclosures about its obligations under certain guarantees and requires the guarantor to recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 clarifies the requirements of SFAS No. 5 "Accounting for Contingencies" relating to guarantees and its initial recognition and measurement provisions are applied on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 does not significantly impact the Company's financial statements or disclosures, nor is it expected to significantly impact future results of operations or financial position.

In December 2002, SFAS No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB No. 123" was issued to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The Company has applied the disclosure provisions of SFAS No. 148 in these consolidated financial statements and accompanying notes.

In January 2003, FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities" was issued which, among other things, provides guidance on identifying variable interest entities ("VIE") and determining when assets, liabilities, non-controlling interests, and operating results of a VIE should be included in a company's consolidated financial statements, and also requires additional disclosures by primary beneficiaries and other significant variable interest holders. Certain disclosure requirements of FIN 46, if applicable, are required for financial statements initially issued after January 31, 2003. Companies with variable interest in variable interest entities created after January 31, 2003 shall apply the provisions of FIN 46 immediately. Public entities with a variable interest in a variable interest entity shall apply the provisions of FIN 46 no later than the first interim or annual reporting period beginning after June 15, 2003. FIN 46 is not expected to significantly impact the Company's financial statements or future results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

US LEC is exposed to various types of market risk in the normal course of business, including the impact of interest rate changes on its investments and debt. As of December 31, 2002, investments consisted primarily of institutional money market funds. A majority of the Company's long-term debt consists of variable rate instruments with interest rates that are based on a floating rate which, at the Company's option, is determined by either a base rate or the London Interbank Offered Rate ("LIBOR"), plus, in each case, a specified margin. Although it is difficult to predict the impact of interest rate changes on the Company's financial statements, the Company has total variable rate bank debt of $127.9 million as of December 31, 2002. Currently, quarterly interest expense, net of interest income, is approximately $2.0 million. At this level, each one percent increase or decrease in interest rates will have approximately a $1.3 million annual impact on the financial statements of the Company, depending somewhat on timing of the borrowing, its maturity and other factors.

Although US LEC does not currently utilize any interest rate management tools, it continues to evaluate the use of derivatives such as, but not limited to, interest rate swap agreements to manage its interest rate risk. As the Company's investments are all short-term in nature and a majority of its long-term debt is at variable short-term rates, management believes the carrying values of the Company's financial instruments approximate fair values.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholders of
US LEC Corp.
Charlotte, North Carolina

We have audited the accompanying consolidated balance sheets of US LEC Corp. and subsidiaries (the "Company") as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity (deficiency) and cash flows for each of the three years in the period ended December 31, 2002. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of US LEC Corp. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Deloitte & Touche LLP

Charlotte, North Carolina
February 24, 2003
(March 20, 2003 as to second paragraph in Note 13)

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands)

	December 31, 2002	December 31, 2001
ASSETS		
Current Assets		
Cash and cash equivalents	$ 25,715	$ 80,502
Restricted cash	1,080	1,300
Accounts receivable (net of allowance of $23,180 and $12,263 at December 31, 2002 and 2001, respectively)	57,989	42,972
Deferred income taxes	2,805	1,840
Prepaid expenses and other assets	8,441	9,030
Total current assets	96,030	135,644
Property and Equipment, Net	178,810	188,436
Other Assets	10,474	9,233
Total Assets	$ 285,314	$ 333,313
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
Current Liabilities		
Accounts payable	$ 10,203	$ 10,747
Accrued network costs	26,952	17,877
Commissions payable	7,886	6,679
Accrued expenses—other	16,015	14,928
Deferred revenue	8,048	6,691
Long-term debt—current portion	306	18,750
Total current liabilities	69,410	75,672
Long-Term Debt	130,311	131,250
Deferred Income Taxes	2,805	1,840
Other Liabilities	6,507	5,721
Commitments and Contingencies (Note 6)		
Series A Mandatorily Redeemable Convertible Preferred Stock (10,000 authorized shares, 235 and 222 shares issued and accrued with redemption values of $235 and $222 at December 31, 2002 and 2001, respectively) (Note 5)	230,272	216,155
Stockholders' Deficiency		
Common stock-Class A, $.01 par value (122,925 authorized shares, 26,895 and 26,388 shares outstanding at December 31, 2002 and 2001, respectively)	269	264
Additional paid-in capital (Note 10)	78,526	76,421
Retained deficit	(232,786)	(172,777)
Unearned compensation—stock options	—	(1,233)
Total stockholders' deficiency	(153,991)	(97,325)
Total Liabilities and Stockholders' Deficiency	$ 285,314	$ 333,313

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2002, 2001, and 2000
(In Thousands, Except Per Share Data)

	2002	2001	2000
Revenue, Net	$250,363	$178,602	$ 114,964
Network Expenses	121,127	90,298	52,684
Depreciation and Amortization	45,062	35,103	24,365
Selling, General and Administrative Expenses	112,878	114,898	80,684
Provision for Doubtful Accounts related to WorldCom (Note 6)	9,500	—	—
Loss on Resolution of Disputed Revenue (Note 8)	—	—	55,345
Provision (Recovery) for Disputed Receivables, Net (Note 6)	—	(7,042)	40,000
Loss from Operations	(38,204)	(54,655)	(138,114)
Other (Income) Expense			
Interest Income	(865)	(3,171)	(4,834)
Interest Expense (Note 4)	8,553	11,870	7,839
Loss Before Income Taxes	(45,892)	(63,354)	(141,119)
Income Tax Benefit (Note 7)	—	—	(23,727)
Net Loss	(45,892)	(63,354)	(117,392)
Less: Preferred Stock Dividends	13,596	12,810	8,758
Less: Accretion of Preferred Stock Issuance Cost	521	491	336
Net Loss Attributable to Common Stockholders	$ (60,009)	$ (76,655)	$(126,486)
Net Loss Attributable to Common Stockholders Per Common Share (Note 11):			
Basic and Diluted	$ (2.26)	$ (2.83)	$ (4.58)
Weighted Average Number of Shares Outstanding (Note 11):			
Basic and Diluted	26,546	27,108	27,618

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	2002	2001	2000
Operating Activities			
Net loss	$(45,892)	$ (63,354)	$(117,392)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	45,062	35,103	24,365
Loss on resolution of disputed revenue	—	—	55,345
Deferred compensation	21	446	150
Deferred income taxes	—	1,840	(23,727)
Provision (recovery) for significant receivables, net	9,500	(7,042)	40,000
Changes in assets and liabilities which provided (used) cash:			
Accounts receivable	(24,517)	25,234	(33,534)
Prepaid expenses and other assets	821	(6,068)	(1,414)
Other assets	(992)	(2,294)	(2,827)
Accounts payable	(841)	2,308	1,131
Deferred revenue	1,356	3,341	1,648
Accrued network costs	9,075	8,575	(4,460)
Customer commissions payable	1,207	(10,193)	5,169
Other liabilities—noncurrent	788	1,406	4,041
Accrued expenses—other	(1,233)	4,727	2,186
Total adjustments	40,247	57,383	68,073
Net cash used in operating activities	(5,645)	(5,971)	(49,319)
Investing Activities			
Purchase of property and equipment	(32,029)	(40,425)	(111,616)
Redemption of certificates of deposit and restricted cash	220	—	(127)
Net cash used in investing activities	(31,809)	(40,425)	(111,743)
Financing Activities			
Net proceeds from issuance of Series A Preferred Stock	—	—	193,760
Proceeds from exercise of stock options, warrants, and ESPP	1,003	1,425	1,105
Proceeds from issuance of subordinated notes and warrants	4,650	—	—
Proceeds from long-term debt	—	20,000	155,000
Payments on long-term debt	(22,062)	—	(97,000)
Payment for deferred loan fees	(924)	(348)	(1,156)
Net cash provided (used) by financing activities	(17,333)	21,077	251,709
Net (Decrease) Increase in Cash and Cash Equivalents	(54,787)	(25,319)	90,647
Cash and Cash Equivalents, Beginning of Period	80,502	105,821	15,174
Cash and Cash Equivalents, End of Period	$ 25,715	$ 80,502	$ 105,821
Supplemental Cash Flow Disclosures			
Cash Paid for Interest	$ 8,957	$ 10,568	$ 7,377
Cash Paid for Taxes	$ —	$ —	$ —

Supplemental Noncash Investing and Financing Activities:

At December 31, 2002, 2001, and 2000, $5,749, $5,452, and $10,696 respectively, of property and equipment additions are included in outstanding accounts payable

At December 31, 2002, $350 was a receivable from certain investors relating to the $5,000 subordinated notes with warrants.

See notes to consolidated financial statements

US LEC CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIENCY)
For the years ended December 31, 2002, 2001 and 2000
(In Thousands)

	Common Stock Class A		Common Stock Class B		Additional Paid-In Capital	Retained Earnings (Deficit)	Unearned Compensation Stock Options	Total
	Shares	Amount	Shares	Amount				
Balance, December 31, 1999 . . .	10,426	104	17,076	171	108,665	30,365	(435)	138,870
Exercise of stock options	28	—	—	—	286	—	—	286
Exercise of warrants	131	1	—	—	372	—	—	373
Tax effects related to stock options and warrants	—	—	—	—	228	—	—	228
Issuance of Shares	108	1	—	—	442	—	—	443
Unearned compensation—stock options	—	—	—	—	(65)	—	216	151
Accretion of preferred stock issuance cost	—	—	—	—	—	(336)	—	(336)
Conversion of Class B Common Shares								—
to Class A Common Shares	241	3	(241)	(3)	—	—	—	—
Deemed distribution to related party	—	—	—	—	(36,115)	—	—	(36,115)
Preferred Stock Dividends . . .	—	—	—	—	—	(8,758)	—	(8,758)
Net loss	—	—	—	—	—	(117,392)	—	(117,392)
Balance, December 31, 2000 . . .	10,934	109	16,835	168	73,813	(96,121)	(219)	(22,250)
Exercise of stock options	2	1	—	—	7	(1)	—	7
Issuance of Shares	618	6	—	—	1,413	—	—	1,419
Unearned compensation—stock options	—	—	—	—	1,460		(1,014)	446
Accretion of preferred stock issuance cost	—	—	—	—		(491)		(491)
Conversion of Class B Common Shares to Class A					—		—	—
Common Shares and effects of recapitalization	14,834	148	(16,835)	(168)	20			—
Preferred stock dividends . . .	—	—	—	—	—	(12,810)	—	(12,810)
Costs Associated with Recapitalization	—	—	—	—	(292)		—	(292)
Net loss	—	—	—	—		(63,354)		(63,354)
Balance, December 31, 2001 . . .	26,388	264	—	—	76,421	(172,777)	(1,233)	(97,325)
Exercise of stock options and warrants					2			2
Issuance of ESPP Stock	507	5			996			1,001
Unearned Compensation—Stock Options (Note 10) . .					(1,213)		1,233	20
Preferred Stock Dividends . . .						(13,596)		(13,596)
Accretion of Preferred Stock Issuance Fees						(521)		(521)
Issuance of Warrants (Note 4)					2,320			2,320
Net Loss						(45,892)		(45,892)
Balance, December 31, 2002 . . .	26,895	$269	—	—	$ 78,526	$(232,786)	$ —	$(153,991)

See Notes to Consolidated Financial Statements

US LEC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the years ended December 31, 2002, 2001, and 2000
(In Thousands, Except Per Share Data)

1. ORGANIZATION AND NATURE OF BUSINESS

The consolidated financial statements include the accounts of US LEC Corp. and its ten wholly owned subsidiaries (the "Company"). All significant intercompany transactions and balances have been eliminated in consolidation. The Company was incorporated in 1996 and in 1998 completed an initial public offering of its common stock.

The Company, through its subsidiaries, provides switched local and long distance voice services, toll free services, frame relay, high speed internet, Asynchronous Transfer Mode ("ATM"), web hosting and other services primarily to medium to large businesses and other organizations in selected markets in the southeastern and mid-Atlantic United States.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition—The Company recognizes revenue on telecommunications services in the period that the service is provided. Revenue is recognized when earned based upon the following specific criteria: (1) persuasive evidence of arrangement exists (2) services have been rendered (3) seller's price to the buyer is fixed or determinable and (4) collectibility is reasonably assured. US LEC's revenue is comprised of two primary components: (1) fees paid by end customers for local, long distance, data and Internet services, and (2) carrier charges primarily including access and reciprocal compensation. End customer revenue includes local, long distance, data and Internet services and is comprised of monthly recurring charges, usage charges, and initial non-recurring charges. Monthly recurring charges include the fees paid by customers for facilities in service and additional features on those facilities. Usage charges consist of usage-sensitive fees paid for calls made. Initial non-recurring charges consist primarily of installation charges. Access charges are comprised of charges paid primarily by inter-exchange carriers ("IXCs") for the origination and termination of inter-exchange toll and toll-free calls and reciprocal compensation. The Company does not resell any incumbent local exchange carrier ("ILEC") dial tone. Reciprocal compensation arises when a local exchange carrier completes a call that originated on another local exchange carrier's network. Reciprocal compensation that is earned as revenue from other local exchange carriers represents compensation for local telecommunications traffic terminated on our network that originates on another carrier's network.

If a significant disputed revenue situation exists, revenue is recorded at amounts at which management believes collectibility is reasonably assured.

Revenues are recorded net of amounts that are due to a customer or outside sales agent pursuant to each respective telecommunications service contract. For the years ended December 31, 2002, 2001 and 2000 amounts incurred under these contracts of $26,208, $22,812 and $18,784, respectively, are netted with gross carrier revenues in the accompanying consolidated financial statements. Early termination fees are recognized when paid and revenue related to billings in advance of providing services is deferred and recognized when earned.

The Company defers installation revenue from contracts with end customers and with other carriers net of certain incentives. The Company is amortizing this revenue over the period of expected benefit, which is the average initial term of the related contracts. As of December 31, 2002 and 2001, the Company had $2,042 and $1,440, respectively, recorded in Deferred Revenue as a current liability on the accompanying Consolidated Balance Sheets. In addition, the Company had $3,191 and $2,428 as of December 31, 2002 and 2001, respectively, recorded in Other Liabilities for the non-current portion of the Deferred Revenue.

Network Expenses—The Company's network expenses are comprised primarily of two types of charges: leased transport charges which comprise approximately 80% of the Company's network expenses and usage sensitive charges which comprise approximately 20% of the Company's network expenses. The Company's leased transport charges are the lease payments incurred by US LEC for the transmission facilities used to connect the Company's customers to the Company owned switch that services that customer and to connect to the ILEC and other carrier networks. US LEC, as part of its "smart-build" strategy, does not currently own any fiber or copper transport facilities. These facilities are leased from various providers including, in many cases, the ILEC. Usage sensitive charges are primarily comprised of usage charges associated with the Company's long distance, access charges and reciprocal compensation owed to other carriers.

Cash and Cash Equivalents—Cash equivalents consist of highly liquid investments with original maturities of three months or less at the time of purchase.

Restricted Cash—The restricted cash balance as of December 31, 2002 and 2001 serves as collateral for letters of credit related to certain office leases. These letters of credit renew annually. Restricted cash is utilized to secure the Company's performance of obligations such as letters of credit to support leases or deposits in restricted use accounts.

Accounts Receivable—The Company maintains an allowance for doubtful accounts for estimated losses resulting from customers' or carriers' failure to make payments on amounts due to the Company. These estimates are based on a number of factors including 1) historical experience, 2) aging of trade accounts receivable, and 3) specific information obtained by the Company on the financial condition and current credit worthiness of customers or carriers.

Deferred Installation Costs—The Company defers installation charges from ILECs related to new customers contracts associated with network and end customer facilities. These costs are comprised of payments for equipment and services provided by external parties in connecting the telecommunication systems of new customers to our telecommunication platform. The Company is amortizing these costs over the average initial term of the related contracts which is 30 months. During the years ended December 31, 2002 and 2001, the Company amortized $4,453 and $2,059, respectively, of deferred installation charges into Network Expenses. As of December 31, 2002 and 2001, the Company had $4,119 and $3,510, respectively, recorded in Other Current Assets and $4,128 and $2,999, respectively, recorded in Other Assets in the accompanying consolidated balance sheets relating to unamortized deferred installation charges.

Property and Equipment—Property and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, except for leasehold improvements as noted below.

The estimated useful lives of the Company's principal classes of property and equipment are as follows:

Telecommunications switching and other equipment	5-9 years
Office equipment, furniture and other	5 years
Leasehold improvements	The lesser of the estimated useful lives or the lease term

The Company capitalized $1,478 and $1,638 in payroll related costs during the years ended December 31, 2002 and 2001, respectively, in accordance with the AICPA Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." These assets are amortized over five years.

Long-Lived Assets—The Company reviews the carrying value of its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of these assets may not be recoverable. Determination of impairment results from a comparison of estimated undiscounted future operating cash flows anticipated to be generated during the remaining life of the assets with their net carrying value. An impairment loss would be recognized as the amount by which the carrying value of the assets exceeds their fair value.

Accrued Network Costs—Accrued network costs include management's estimate of charges for direct access lines, facility charges, outgoing and incoming minutes, reciprocal compensation and other costs of revenue for a given period for which bills have not yet been received by the Company. Management's estimate is developed from the number of lines and facilities in service, minutes of use and contractual rates charged by each respective service provider. Subsequent adjustments to this estimate may result when actual costs are billed by the service provider to the Company. However, management does not believe such adjustments will be material to the Company's financial statements.

Debt Issuance Cost—The Company capitalizes costs associated with securing long-term debt and amortizes such costs over the term of the debt agreement. The Company had deferred debt issuance costs (net of accumulated amortization of $2,619 and $1,765) of $4,290 and $3,922 as of December 31, 2002 and 2001, respectively, recorded in other assets on the accompanying consolidated balance sheets that are being amortized over the life of the related debt agreement. (See Note 4)

Fair Value of Financial Instruments—Management believes the fair values of the Company's financial instruments, including cash equivalents, restricted cash, accounts receivables, accounts payable, accrued network costs and subordinated notes approximate their carrying value. In addition, because the majority of long-term debt consists of variable rate instruments, management believes their carrying values approximate fair values.

Income Taxes—Income taxes are provided for temporary differences between the tax and financial accounting basis of assets and liabilities using the liability method. The tax effects of such differences, as reflected in the balance sheet, are at the enacted tax rates expected to be in effect when the differences reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized and are reversed at such time that realization is believed to be more likely than not.

Concentration of Risk—The Company is exposed to concentration of credit risk principally from trade accounts receivable due from end customers and carriers. The Company's end customers are located in the southeastern and mid-Atlantic United States. The Company performs ongoing credit evaluations of its end customers but does not require collateral deposits from a majority of its end customers. The Company is exposed to additional credit risk due to the fact that the Company's most significant trade receivables are from a few large telecommunications carriers.

The Company is dependent upon certain suppliers for the provision of telecommunications services to its customers. The Company has executed interconnection agreements for all states in which it operates.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. Significant estimates relate to revenue recognition, the allowance for doubtful accounts receivable, estimated end customer contract life, accrual of network costs payable to other telecommunications entities, income tax valuation allowance, and conclusions regarding the impairment of and the estimated useful lives of fixed assets. Any difference between the amounts recorded and amounts ultimately realized or paid will be adjusted prospectively as new facts become known.

Advertising—The Company expenses advertising costs in the period incurred. Advertising expense amounted to $1,287, $1,473 and $1,190 for 2002, 2001 and 2000, respectively.

Significant Customer—In 2002, 2001 and 2000 BellSouth, operating in the majority of the Company's markets, accounted for approximately 5%, 10% and 15%, respectively, of the Company's net revenue. The majority of this revenue was generated from reciprocal compensation. Although reciprocal compensation owed to the Company by BellSouth is not customer revenue in the traditional sense, BellSouth is disclosed here due to their significance. At December 31, 2002, 2001 and 2000, BellSouth accounted for 5%, 16% and 70%, of the Company's total accounts receivable before allowance, respectively. The majority of such receivables and revenues in 1999, resulted from traffic associated with Metacomm, LLC ("Metacomm"), a customer of the Company and BellSouth, which became a related party to the Company during 1998. During 2000, Metacomm ceased to be a customer of BellSouth and the Company and no revenue was recorded in 2000 related to Metacomm traffic. As a result of the March 31, 2000 order issued by the North Carolina Utilities Commission ("NCUC") denying reciprocal compensation to the Company from traffic associated with the Metacomm network, the Company recorded a pre-tax, non-recurring, non-cash charge of approximately $55,000. During 2001, the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which they resolved outstanding reciprocal compensation disputes in the various states in which both operate and other past payments (see Note 6 to the Company's consolidated financial statements).

Stock Based Compensation—The Company measures the compensation cost of its stock option plan under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees", as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation". Under the provisions of APB No. 25, compensation cost is measured based on the intrinsic value of the equity instrument awarded. Under the provisions of SFAS No. 123, compensation cost is measured based on the fair value of the equity instrument awarded.

Had compensation cost for the employee warrants and stock options been determined consistent with SFAS No. 123, the Company's net loss and net loss per share would approximate the following proforma amounts:

	2002	2001	2000
Net loss, as reported	$(45,892)	$(63,354)	$(117,392)
Preferred dividends	(13,596)	(12,810)	(8,758)
Accretion of preferred stock issuance fees	(521)	(491)	(336)
Net loss attributable to common shareholders, as reported	$(60,009)	$(76,665)	$(126,486)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	21	446	150
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(4,106)	(7,546)	(4,194)
Pro forma net loss	$(54,094)	$(83,755)	$(130,530)
Weighted average shares outstanding	26,546	27,108	27,618
Loss per share:			
Basic and diluted, as reported	$ (2.26)	$ (2.83)	$ (4.58)
Basic and diluted, pro forma	$ (2.41)	$ (3.09)	$ (4.73)

The Company estimated the fair value for both the stock options and the warrants using the Black-Scholes model assuming no dividend yield in 2002, 2001 and 2000; volatility of 80%, 80%, and 80%, for 2002, 2001, and 2000, respectively, an average risk-free interest rate of 3.0%, 6.0%, and 6.5%, for 2002, 2001, and 2000, respectively, an expected life of 12 months for the warrants issued prior to 2002 and 4.7, 4.9 and 5.0 years for the stock options in 2002, 2001, and 2000 respectively. The weighted average remaining contractual life of warrants and stock options outstanding at December 31, 2002 was 9.6 years and 7.3 years, respectively.

The Company estimated the fair value of the Employee Stock Purchase Plan shares based upon the stock price at December 31, 2001 (the "issue date"). Compensation cost was estimated based upon the intrinsic value of the award at the issue date.

Reclassifications—Certain reclassifications have been made to 2000 and 2001 amounts to conform to the 2002 presentation.

Recent Accounting Pronouncements—Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and hedging activities by requiring that entities recognize all derivatives as either assets or liabilities at fair market value on the balance sheet. The adoption of SFAS No. 133 did not have a material effect on its results of operations as it does not currently hold any derivative instruments or engage in hedging activities.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS 121, "Accounting for Impairment or Disposal of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", but retains many of its fundamental provisions. SFAS 144 also supercedes the accounting and reporting provisions of APB Opinion 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." This statement retains the requirement to report discontinued operations separately from continuing operations and expands the scope of transactions that qualify as discontinued operations. SFAS No. 144 was effective for the Company for financial statements issued for the fiscal year beginning January 1, 2002. The adoption of SFAS No. 144 did not have a material effect on the Company's results of operations.

In April 2002, SFAS No. 145 "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB No. 13, and Technical Corrections" was issued. SFAS No. 145, among other things, eliminates FASB Statement No. 4 "Reporting Gains and Losses from Extinguishment of Debt" which required gains and losses from debt extinguishments to be aggregated and, if material, classified as an extraordinary item net of associated income tax effects, and also eliminates the exception to applying Accounting Principles Board (APB) Opinion No. 30. As such, gains and losses from debt extinguishments should be classified as extraordinary items only if they meet certain criteria in APB Opinion No. 30. Such criteria distinguishes transactions that are part of an entity's recurring operations from those that are unusual or infrequent or that meet the criteria of APB Opinion No. 30 for classification as an extraordinary item. The provision of SFAS No. 145 related to the rescission of SFAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. The application of such provisions of SFAS No. 145 is not expected to have a material effect on the Company's results of operations.

In June 2002, SFAS No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" was issued and is effective for such activities initiated after December 31, 2002. SFAS No. 146 specifies, among other things, the financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3 "Liability Recognition for Certain Employee Benefits and Other Costs to Exit an Activity, including Certain Costs Incurred in a Restructuring." The adoption of SFAS No. 146 is not expected to significantly impact the Company's financial statements or future results of operations.

In November 2002, FASB Interpretation No. 45 ("FIN 45") "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" was issued which, among other things, expands guarantor financial statement disclosures about its obligations under certain guarantees and requires the guarantor to recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 clarifies the requirements of SFAS No. 5 "Accounting for Contingencies" relating to guarantees and its initial recognition and measurement provisions are applied on a prospective basis to guarantees issued or modified after December 31, 2002. FIN 45 does not significantly impact the Company's financial statements or disclosures, nor is it expected to significantly impact future results of operations or financial position.

In December 2002, SFAS No. 148 "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of FASB No. 123" was issued to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The Company has applied the disclosure provisions of SFAS No. 148 in these consolidated financial statements and accompanying notes.

In January 2003, FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities" was issued which, among other things, provides guidance on identifying variable interest entities ("VIE") and determining when assets, liabilities, non-controlling interests, and operating results of a VIE should be included in a company's consolidated financial statements, and also requires additional disclosures by primary beneficiaries and other significant variable interest holders. Certain disclosure requirements of FIN 46, if applicable, are required for financial statements initially issued after January 31, 2003. Companies with variable interest in variable interest entities created after January 31, 2003 shall apply the provisions of FIN 46 immediately. Public entities with a variable interest in a variable interest entity shall apply the provisions of FIN 46 no later than the first interim or annual reporting period beginning after June 15, 2003. FIN 46 is not expected to significantly impact the Company's financial statements or future results of operations.

3. PROPERTY AND EQUIPMENT

Property and equipment at December 31, is summarized by major class as follows:

	2002	2001
Telecommunications switching and other equipment	$ 185,195	$161,178
Office equipment, furniture and other	82,627	72,805
Leasehold improvements	28,096	28,176
	295,918	262,159
Less accumulated depreciation and amortization	(117,108)	(73,723)
Total	$ 178,810	$188,436

4. LONG-TERM DEBT

On December 31, 2002, the Company amended its senior secured credit facility. As a condition to amending the senior secured credit facility, the Company's senior lenders required an investment of $5,000 in the Company. Therefore, concurrent with amending the senior secured credit facility, the Company received gross proceeds of $5,000 through the issuance of 11% subordinated notes with a stated value of $5,000 (the

"Subordinated Notes") and warrants to purchase shares of the Company's common stock (the "2002 Warrants"). The $5,000 was invested by a group of private investors that included the Company's founders, Richard T. Aab and Tansukh V. Ganatra. Mr. Aab currently serves as Chairman of the Company and Mr. Ganatra serves as a director.

As amended, the senior secured credit facility is comprised of a $102,937 term loan and a $25,000 revolving credit facility. The Company made an $8,000 principal payment on the term loan in connection with the amendment, reducing the outstanding balance from $110,937 to $102,937. The interest rate for the facility is a floating rate based, at the Company's option, on a base rate (as defined in the loan agreement) or the London Interbank Offered Rate, plus a specified margin. Advances under the credit agreement as of December 31, 2002 bear interest at an average annual rate of approximately 5.75%. The facility is secured by a security interest in substantially all of the Company's assets.

In amending the senior secured credit facility, the Company deferred $30,000 of term loan principal payments from 2003 and 2004 to 2005 and 2006; deferred repayment of the $25,000 outstanding under the revolving facility from 2005 to 2006; agreed to pay additional interest on the deferred portion of the term loan amounts at an annual rate of 10%, payable upon the maturity of the loan in December 2006, and agreed to revised financial covenants.

As amended, in addition to regular scheduled quarterly principal payments, the Company is required to make certain mandatory prepayments of principal equal to a portion of the interest paid to the Subordinated Note holders. These mandatory prepayments are scheduled to be $306, $335, $340 and $337 in 2003, 2004, 2005 and 2006 respectively. There are no other regular scheduled principal payments due during 2003, $500 in principal payments are due in March and June 2004, $3,188 is due in September 2004, $6,250 is due in December 2004, $11,446 is payable in each quarter of 2005 and the first three quarters of 2006, and a final principal payment of $11,064 is due when the term loan matures in December 2006.

The revised financial covenants were designed to conform to the business plan provided by the Company to its senior lenders in connection with the amendment. The covenants include: achievement of minimum levels of earnings before interest, taxes, depreciation, amortization and credit restructuring costs; maintenance of a minimum specified gross margin percentage (as defined); limits on the amount of capital expenditures; maintenance of minimum levels of unrestricted cash; and beginning in March 2005, maintenance of specified total leverage, cash interest coverage and minimum fixed charge coverage ratios. Measurements of the revised covenants will commence in 2003. Management believes that the Company will be in compliance with all financial covenants for a period at least through December 2003 based on projected operating results. The operating results reflected in the business plan are dependent on the Company meeting targets for new customers, customer retention, customer usage, billing rates, gross margins and selling, general, and administrative costs and as a result involve some degree of uncertainty. Should any of these assumptions not be achieved for a particular period, it is possible that a financial covenant will not be met for the period through December 2003. Although there can be no assurances, management believes if this were to occur it would be able to obtain the necessary waivers or amendments from its lenders. Should such waivers or amendments not be obtained, the lenders would have the right under the credit agreement to certain remedies including acceleration of debt repayment.

The $5,000 in gross proceeds received on December 31, 2002 was allocated, based on the approximate relative fair values, $2,680 to the Subordinated Notes and $2,320 to the 2002 Warrants. The Subordinated Notes are included in long-term debt and the 2002 Warrants are included in additional paid-in-capital in the accompanying consolidated balance sheet as of December 31, 2002. The Subordinated Notes bear interest at an annual rate of 11% payable monthly, have a five-year term and are subordinated to the senior credit facility. The discount on the Subordinated Notes will be amortized over the term of the notes. The Subordinated Note holders received warrants to purchase 1,737 and 895 shares of the Company's common stock at an exercise price of $1.90 and $2.06 per share, respectively. The 2002 Warrants are exercisable immediately and expire upon the earlier of 10 years or five years from the repayment in full of the Subordinated Notes. The Company granted the 2002 Warrant holders demand and piggyback registration rights with respect to the common stock underlying the 2002 Warrants.

Scheduled maturities of long-term debt are as follows:

Year ending December 31:	Senior Secured Credit Facility	Subordinated Notes	Total
2003	306	—	306
2004	10,772	—	10,772
2005	46,122	—	46,122
2006	70,737	—	70,737
2007	—	2,680	2,680
Total	127,937	2,680	130,617

5. SERIES A MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED STOCK

On April 11, 2000, the Company issued $200,000 of its Series A Mandatorily Redeemable Convertible Preferred Stock (the "Series A Preferred Stock") to affiliates of Bain Capital, Inc. (Bain) and Thomas H. Lee Partners, L.P. (THL). The Series A Preferred Stock earns dividends on a cumulative basis at an annual rate of 6%, payable quarterly in shares of Series A Preferred Stock for three years, and at US LEC's option, in cash or shares of Series A Preferred Stock over the next seven years. In addition, the Series A Preferred Stock participates on a pro rata basis in the dividends payable to common shareholders. As of December 31, 2002, the Company issued $35,164 in Series A Preferred Stock Dividends. In the event of any liquidation, dissolution or other winding up of the affairs of the Company, the holders of Series A Preferred Stock are entitled to be paid in preference to any distribution to holders of junior securities, an amount in cash, equal to $1,000 per share plus all accrued and unpaid dividends on such shares. On or after April 11, 2001, the holders of the shares of Series A Preferred Stock may convert all or a portion of their shares into shares of Class A Common Stock at a set conversion price. The initial conversion price of $35.00 has been adjusted to approximately $30.70 as of December 31, 2002 pursuant to the anti-dilution provisions of the Series A Preferred Stock. The conversion price was further adjusted on January 15, 2003 to approximately $30.06 primarily as a result of the warrants issued in the transaction acquiring certain assets of Eagle Communications, Inc. (see Note 13) and pursuant to the anti-dilution provisions of the Series A Preferred Stock. The holders of the Series A Preferred Stock may also convert all or a portion of their shares into Class A Common Stock at a set conversion price prior to April 11, 2010 in the event of a change in control or an acquisition event. Each holder of the Series A Preferred Stock may redeem all or a portion of their Series A Preferred Stock at a price equal to 101% of $1,000 per share plus all accrued dividends on such shares after the occurrence of a change in control and for a period of 60 days following such event. At any time on or after April 11, 2003, the Company may redeem all of the outstanding shares of Series A Preferred Stock, at a price equal to $1,000 per share plus all accrued and unpaid dividends on such shares, only if the market price of a share of common stock for 30 consecutive trading days during the 90 day period immediately preceding the date of the notice of redemption is at least 150% of the then effective conversion price and the market price of a share of common stock on the redemption date is also at least 150% of the then effective conversion price. All outstanding shares of the Series A Preferred Stock are subject to mandatory redemption on April 11, 2010. Proceeds to the Company, net of commissions and other transaction costs, were approximately $194,000.

The Company incurred $6,240 in expenses related to the issuance of the Series A Preferred Stock. The cost will be accreted against Retained Earnings (Deficit) over the life of the agreement. For the years ended December 31, 2002 and 2001, the Company accreted $521 and $491 of these costs, respectively. As of December 31, 2002 and 2001, the Company had $4,892 and $5,413 in Series A Preferred Stock issuance costs, respectively, netted with Series A Mandatorily Redeemable Convertible Preferred Stock on its Consolidated Balance Sheet.

6. COMMITMENTS AND CONTINGENCIES

The deregulation of the telecommunications industry, the implementation of the Telecom Act enacted on February 8, 1996 and the distress of many carriers in the wake of the downturn in the telecommunications industry have involved numerous industry participants, including the Company, in lawsuits, proceedings and arbitrations before state and federal regulatory commissions, private arbitration organizations such as the American Arbitration Association, and courts over many issues important to the financial and operational success of the Company. These issues include the interpretation and enforcement of interconnection agreements, the terms of interconnection agreements the Company may adopt, operating performance obligations, reciprocal compensation, access rates, access rates applicable to different categories of traffic such as traffic originating from or terminating to cellular or wireless users and the jurisdiction of traffic for compensation purposes. The Company anticipates that it will continue to be involved in various lawsuits, arbitrations and proceedings over these and other material issues. The Company anticipates also that further legislative and regulatory rulemaking will occur—on the federal and state level—as the industry deregulates and as the Company enters new markets or offers new products. Rulings adverse to the Company, adverse legislation, or changes in governmental policy on issues material to the Company could have a material adverse effect on the Company's financial condition or results of its operations. Revenue recognized and amounts recorded as allowances for doubtful accounts in the accompanying financial statements have been determined considering the impact, if any, of the items described below. Except as noted below, items described herein did not impact the accompanying consolidated financial statements.

Reciprocal Compensation—On April 27, 2001, the Federal Communications Commission ("FCC") released an Order on Remand and Report and Order (the "Remand Order") addressing inter-carrier compensation for traffic terminated to Internet service providers ("ISPs"). The interpretation and enforcement of the Remand Order will likely be the most important factor in the Company's efforts to collect reciprocal compensation for ISP-bound traffic in the future. In the Remand Order, the FCC addressed a number of important issues, including the rules under which carriers are to compensate each other for traffic terminated to ISPs and the rates applicable for ISP-bound traffic as well as traffic bound to other customers.

While the Remand Order provides greater certainty about the Company's right to bill for traffic terminated to ISPs, the effect of the Remand Order on the Company will depend on how it is interpreted and enforced. In particular, there are uncertainties as to whether the Remand Order has any effect on the Company's pending arbitral, state regulatory commission and judicial proceedings seeking to collect compensation for traffic previously terminated to ISPs; whether certain provisions of the Remand Order will be applied state-by-state, market-by-market and/or carrier-by-carrier; whether the limitations on growth of ISP traffic in the Remand Order will survive legal challenge; and whether the incumbent carrier will efficiently trigger the rate reductions and other limitations set forth in the Remand Order.

On May 3, 2002, the U.S. Court of Appeals for the District of Columbia (the "D.C. Circuit") rejected the FCC's legal analysis in the Remand Order and again remanded the order to the FCC for further review (the

"Second Remand"), but the D.C. Circuit did not vacate the Remand Order. As such, the ISP compensation structure established by the FCC in the Remand Order remains in effect. It is unclear at this time whether, how or when the FCC will respond to the Second Remand, how the Second Remand affects pending disputes over reciprocal compensation for ISP traffic, how the Remand Order will be interpreted or whether affected parties will undertake new challenges to the ISP compensation structure established by the Remand Order.

If the Remand Order or the Second Remand were to be interpreted in a manner adverse to the Company on all or any of the issues, or if the Remand Order is modified as a result of the Second Remand or other pending or new legal challenges, it could have a material adverse effect on the Company's future operations.

On October 3, 2001 the Company and BellSouth entered into a settlement agreement (the "Settlement Agreement") by which the Company and BellSouth resolved outstanding reciprocal compensation receivables in the various states in which both of us operate and other past payments. BellSouth agreed to pay US LEC approximately $31,000, in addition to approximately $10,000 it paid in August 2001, to resolve those issues for periods prior to the effective date of the Remand Order. The Settlement Agreement imposed on the parties certain obligations regarding the payment of reciprocal compensation in the future. The Settlement Agreement also provides that the payments made for periods prior to the effective date of the Remand Order are not subject to adjustment as a result of subsequent changes in the Remand Order (See Allowance for Doubtful Accounts below).

In September 2001, the Company filed a proceeding with the Virginia State Corporation Commission ("VSCC") and the FCC seeking to collect reciprocal compensation from Verizon payable for traffic bound for ISPs as well as other customers. The VSCC declined jurisdiction over the dispute. In January 2002, the FCC accepted jurisdiction over the dispute. Prior to the Company's filing a complaint against Verizon at the FCC, and in a separate, but related, case, the FCC held that the contract with Verizon (that the Company had adopted) did not obligate the parties to pay reciprocal compensation for traffic bound for ISPs. That decision is on appeal. In June 2002, Verizon filed a complaint against the Company in the United States District Court for the Eastern District of Virginia seeking a declaratory ruling that Verizon is not obligated to pay the Company reciprocal compensation for traffic bound for ISPs under the agreement adopted by the Company. The Company moved to dismiss Verizon's complaint based on a number of factors; the Court took the Company's motion under advisement and directed the Company to initiate a proceeding against Verizon at the FCC. On September 5, 2002, the Company filed a Formal Complaint with the FCC's Enforcement Bureau seeking to collect reciprocal compensation from Verizon for traffic bound for ISPs. Verizon answered, denying liability. Pending the outcome of the appeal in the related case, the FCC converted the Company's case against Verizon into an informal complaint and has placed it on an administrative hold In light of these developments, as well as the Second Remand, the Company cannot predict when this dispute will be resolved or whether the Company will ultimately be successful.

Disputed Access Revenues—A number of IXCs have refused to pay access charges to competitive local exchange carriers ("CLECs"), including the Company, alleging that the access charges exceed the rates charged by the ILECs, as well as disputing the rates applicable to different categories of traffic and the jurisdiction of traffic for compensation purposes. Currently there are a number of court cases, regulatory proceedings at the FCC and legislative efforts involving such challenges. The Company cannot predict the outcome of these cases, regulatory proceedings and legislative efforts or their impact on access rates.

On April 27, 2001, the FCC released its Seventh Report and Order and Further Notice of Proposed Rulemaking (the "Access Order") in which it established a benchmark rate at which a CLEC's interstate access charges will be presumed to be reasonable and which CLECs may impose on IXCs by tariff. The Access Order addresses a number of issues important to how CLECs charge IXCs for originating and terminating interstate toll and toll free traffic.

The Access Order should provide certainty as to the Company's right to bill IXCs for interstate access at rates at or below the FCC benchmark even though above those tariffed by the ILECs. Notwithstanding the apparent certainty created by the Access Order, its effect on the Company will depend on how the Access Order is interpreted and enforced and the outcome of appeals currently pending. If the Access Order is interpreted or enforced in a manner adverse to the Company as it relates to periods prior to the effective date, such result could have a material adverse effect on the Company.

On May 30, 2001, the FCC issued a decision in AT&T Corp. v. Business Telecom Inc. (the "BTI Decision"), in which the FCC determined that the interstate access rates charged by Business Telecom, Inc. ("BTI") were not just and reasonable. The FCC determined that just and reasonable rates for BTI were properly based upon the lowest band of rates charged by the National Exchange Carriers Association ("NECA"). The FCC based this holding on the limited evidence before it, tending to show that BTI's operations were similar to those of small, urban ILECs, many of whom charge the lowest band NECA rates. Appeals of the BTI Decision were subsequently withdrawn. As with the Access Order described above, the BTI Decision's effect on the Company will depend on how the order is interpreted. If the BTI Decision is interpreted in a manner adverse to the Company, such result could have a material adverse effect on the Company.

By settlement dated October 5, 2001, Sprint and the Company resolved their litigated dispute over access charges. Sprint paid the Company approximately $8,000, in addition to approximately $1,500 it paid in the four months preceding the settlement, in payment of past due invoices for periods through July 2001 (See Allowance for Doubtful Accounts below).

Due to the federal bankruptcy filing by WorldCom, during the quarter ended June 30, 2002, the Company established an additional provision of $9,500 for doubtful accounts for the remaining outstanding receivables owed to the Company by WorldCom. The Company is pursuing its claim for the payment of all outstanding charges in the WorldCom bankruptcy proceeding, but is fully reserved for the amount due from WorldCom for all pre-petition amounts.

On September 18, 2002, US LEC filed a Petition for Declaratory Ruling with the FCC requesting that the FCC reaffirm its prior positions that access charges can be collected by local exchange carriers in connection with calls originating or terminating on the networks of wireless carriers. A number of different carriers have filed comments in support of, and in opposition to, US LEC's petition. In addition ITC^DeltaCom Communications, Inc. ("ITC") has filed a lawsuit against the Company alleging that in an effort to collect access charges from ITC for originating wireless traffic destined for ITCs toll-free customer, US LEC blocked certain signaling data for calls originated on the networks of US LEC's wireless carrier customers that would allow the call to be identified as a wireless call. ITC's lawsuit alleges claims based on a number of different legal theories. US LEC, through counsel, has investigated ITC's allegations, and has discovered no evidence to support ITC's claims. US LEC has denied ITC's allegation and asserted a counterclaim against ITC to recover outstanding access charges owed by ITC. The Company anticipates dispositive motions will be filed shortly as the Company seeks early resolution of the case. In addition to the lawsuit filed in federal court, ITC also filed an Informal Complaint at the FCC challenging US LEC's right to recover access charges on calls originating from wireless carriers. The informal complaint was closed without the FCC taking any action. The Company also received a separate request for information from the Enforcement Bureau of the FCC concerning the Company's billing for wireless traffic and its methods of billing. The Company intends to respond to the FCC's requests. Further, the Company will discuss with the FCC its belief that no additional proceedings are warranted by the agency beyond those already pending on the issue of terminating calls originating on the networks of wireless carriers, including the proceeding commenced by US LEC requesting guidance to the industry on the issue. If the FCC does not reaffirm its prior guidance, the inability of US LEC to recover access charges from IXCs for traffic originating on the networks of wireless carrier customers could have a material negative impact on US LEC's results of operations.

In light of the general conditions prevailing in the telecommunications industry, there is a risk of further delinquencies, nonpayment or bankruptcies by other telecommunications carriers that owe outstanding amounts derived from access and facility revenues billed by the Company. Such events, in the aggregate, could have an adverse effect on the Company's performance in future periods. The Company is unable to predict such events at this time.

Legislation—Periodically, legislation has been introduced in the U.S. House of Representatives or the U.S. Senate to alter or amend the Telecom Act. It is the Telecom Act which opened the local telephone markets for competition and outlines many of the ground rules pursuant to which the ILECs and the CLECs operate with respect to each other. The Company anticipates that additional efforts will be made to alter or amend the Telecom Act. The Company cannot predict whether any particular piece of legislation will become law and how the Telecom Act might be modified. The passage of legislation amending the Telecom Act could have a material adverse effect on the Company and its future financial results.

Interconnection Agreements with ILECs—The Company has agreements for the interconnection of its networks with the networks of the ILECs covering each market in which US LEC has installed a switching platform. US LEC may be required to negotiate new interconnection agreements as it enters new markets in the future. In addition, as its existing interconnection agreements expire, it will be required to negotiate extension or replacement agreements. The Company recently concluded interconnection arbitrations with Verizon in order to obtain new interconnection agreements on terms acceptable to the Company and is awaiting results from those arbitrations from several PUCs. There can be no assurance that the Company will successfully negotiate, successfully arbitrate or otherwise obtain such additional agreements for interconnection with the ILECs or renewals of existing interconnection agreements on terms and conditions acceptable to the Company.

Interconnection with Other Carriers—The Company anticipates that as its interconnections with various carriers increase, the issue of seeking compensation for the termination or origination of traffic whether by reciprocal arrangements, access charges or other charges will become increasingly complex. The Company does not anticipate that it will be cost effective to negotiate agreements with every carrier with which the Company exchanges originating and/or terminating traffic. The Company will make a case-by-case analysis of the cost effectiveness of committing resources to these interconnection agreements or otherwise billing and paying such carriers.

Allowance for Doubtful Accounts—The Company recorded a significant charge relating to disputed receivables in the fourth quarter of 2000. The $52,000 provision is netted on the Company's consolidated statement of operations against a $12,000 reduction in commissions payable on those receivables, resulting in the $40,000 provision on the Company's consolidated statement of operations. Management believed that this charge was necessary due to the uncertainty related to current regulatory proceedings related to reciprocal compensation and other access charges and the continued refusal by ILECs, principally BellSouth, to pay amounts believed by the Company to be owed to it under applicable interconnection agreements and due to Sprint's failure to pay US LEC's access charges. The Company resolved its disputes with both BellSouth and Sprint during 2001. Included in the 2001 consolidated statements of operations is an amount approximating $7,042, representing a net recovery of amounts previously recorded as reserves for disputed receivables and certain other related accruals. Additionally, charges to bad debt expense for the years ending December 31, 2002, 2001 and 2000 were $4,970, $6,586 and $988, respectively.

Leases—The Company leases all of its administrative and switch sites under operating lease arrangements. Total rent expense on these leases amounted to $8,140, $7,951 and $5,734 in 2002, 2001 and 2000, respectively. The Company's restricted cash balance as of December 31, 2002 and 2001 serves as collateral for letters of credit for some of these office leases.

Future minimum rental payments under operating leases having initial or remaining non-cancelable lease terms in excess of one year are as follows:

2003	$ 7,415
2004	7,219
2005	6,507
2006	5,824
2007	5,744
Beyond	17,208
	$49,917

7. INCOME TAXES

The provision for income taxes consists of the following components:

	2002	2001	2000
Current—Charge equivalent to net tax benefit related to stock options and warrants	$ —	$ —	$ 281
Deferred			
Federal	—	—	(19,545)
State	—	—	(4,463)
	—	—	(24,008)
Total provision for income taxes	$ —	—	$(23,727)

The reconciliation of the statutory federal income tax rate to the Company's federal and state overall effective income tax rate is as follows:

	2002	2001	2000
Statutory federal rate	(35.00)%	(35.00)%	(35.00)%
State income taxes	—	—	(2.06)
Change in valuation allowance	33.21	33.59	20.05
Miscellaneous	1.79	1.41	.20
Effective tax rate	0%	0%	(16.81)%

Deferred income taxes reflect the net tax effects of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Significant components of the Company's deferred tax assets and liabilities as of December 31, 2002, 2001 and 2000 are as follows:

	2002	2001	2000
Deferred tax assets:			
Net operating loss carryforward	$101,415	$ 82,322	$ 57,568
Deferred state taxes and other	—	120	—
Accrued expenses	10,759	5,908	1,293
Deferred tax assets	112,174	88,350	58,861
Less: Valuation Allowance	(79,689)	(61,045)	(35,669)
Total deferred tax assets	32,485	27,305	23,192
Deferred tax liabilities:			
Net deferred revenues	3,288	—	3,747
Depreciation and amortization	26,399	26,083	18,937
Capitalized Salaries and Interest	1,948	1,222	508
Accrued Interest	850	—	—
Total deferred tax liabilities	32,485	27,305	23,192
Net Deferred Taxes	$ 0	$ 0	$ 0

For the years ended December 31, 2002 and 2001, a valuation allowance has been provided against the net deferred tax assets since management cannot predict, based on the weight of available evidence, that it is more likely than not that such assets will be ultimately realized.

At December 31, 2002, the Company has net operating loss carryforwards for federal and state tax purposes of approximately $239,061. Such losses begin to expire for federal and state purposes in 2017 and 2012, respectively.

8. RELATED PARTIES

During 1998, the Company's majority stockholder acquired an indirect controlling interest in Metacomm. Metacomm was engaged in the business of developing and operating a high-speed data network in North Carolina, and was a customer of the Company and BellSouth during 1999 and 1998. On March 31, 2000 the NCUC issued an order that relieved BellSouth from paying reciprocal compensation to the Company for any minutes of use attributable to Metacomm. The Company recorded no revenue associated with the Metacomm network in 2002, 2001 or 2000. As a result of the order, the Company subsequently recorded a pre-tax, non-recurring, non-cash charge of approximately $55,000 in the first quarter of 2000. The charge was composed of the write-off of approximately $153,000 in receivables related to reciprocal compensation revenue offset by previously established reserves of $39,000 and a reduction of $59,000 in commissions payable to Metacomm.

9. EMPLOYEE BENEFIT PLAN

The Company has a 401(k) savings plan under which employees can contribute up to 15% of their annual salary. For 2002, 2001, and 2000, respectively, the Company made matching contributions to the plan totaling $1,018, $1,006 and $757 based on 50% of the first 6% of an employee's contribution to the plan.

10. STOCKHOLDERS' EQUITY

Common Stock—In 2001, prior to the completion of the recapitalization transaction described below, the Company had previously authorized and issued two classes of common stock, Class A and Class B. As a result of the aforementioned recapitalization, 2,000 shares of Class B Common stock were cancelled and the remaining 14,000 shares of Class B were converted into the same number of Class A Common Shares. The rights of holders of the Class A Common Stock are entitled to one vote per share in the election of the members of the Board of Directors.

Employee Stock Purchase Plan—In May 2000, the Company's shareholders approved and the Company adopted the Employee Stock Purchase Plan (the "Stock Purchase Plan"). Under the terms of the Stock Purchase Plan, as of September 1, 2000 ("the effective date"), the Board of Directors reserved 1,000 shares of common stock for the plan. The Stock Purchase Plan provides for specified offering periods (initially the period from the effective date to December 31, 2000 and thereafter, the six month periods between January and June and July and December of each respective year) during which an eligible employee is permitted to accumulate payroll deductions in a plan account for the purchase of shares of Class A Common Stock. Substantially all employees may elect to participate in the Stock Purchase Plan by authorizing payroll deductions in an amount not exceeding ten percent (10%) of their compensation payable during the offering period, and not more than $25 annually. The purchase price per share will be the lower of 85% of the market value of a share as of the first day of each offering period or 85% of the market value of a share as of the last day of each offering period. The Company is presently authorized to issue 2,000 shares of common stock under the Stock Purchase Plan. The Company issued share amounts of 197, 310 and 323 shares at a purchase price of $1.91, $1.99 and $2.30 per share, respectively, which represents a 15% discount to the closing price on December 31, 2002, June 30, 2002 and December 31, 2001, respectively.

Stock Option Plan—In January 1998, the Company adopted the US LEC Corp. 1998 Omnibus Stock Plan (the "Plan"). In August 1998, the Company filed a registration statement to register (i) 1,300 shares of Class A Common Stock reserved for issuance under the Plan and (ii) 180 shares of Class A Common Stock reserved for issuance upon the exercise of nontransferable warrants granted by the Company to employees. In April 1999, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 1,300 shares to 2,000 shares and in May 1999, the Company filed a registration statement to register these additional 700 shares. In May 2000, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 2,000 shares to 3,500 shares and in August 2000, the Company filed a registration statement to register these additional 1,500 shares. In May 2001, the Company's stockholders voted to amend the Plan to increase the number of Class A Common Stock reserved for issuance under the Plan from 3,500 shares to 5,000 shares and in 2001, the Company filed a registration statement to register these additional 1,500 shares. Under the amended Plan, 5,000 shares of Class A Common Stock have been reserved for issuance for stock options, stock appreciation rights, restricted stock, performance awards or other stock-based awards. Options granted under the Plan are at exercise prices determined by the Board of Directors or its Compensation Committee. For incentive stock options, the option price may not be less than the market value of the Class A Common Stock on the date of grant (110% of market value for greater than 10% stockholders).

In January 1998, the Company granted incentive stock options to substantially all employees to purchase an aggregate of 183 shares of Class A Common Stock at $10 per share (fair market value on date of grant was $13 per share). These options began vesting annually in four equal installments beginning in January 1999. The Company recorded deferred compensation of $548 in 1998 associated with these options, which was amortized to compensation expense over the four-year vesting period. The Company amortized $5, $73 and $60 for

2002, 2001 and 2000, respectively, to compensation expense relating to these options, after consideration of forfeitures.

Also, during 1998, the Company granted to an employee an option to purchase 360 shares of Class A Common Stock at $13 per share (fair market value on the date of grant was $14 per share). The Company recorded deferred compensation of $360 associated with these options and did amortize this amount to compensation expense over the four year vesting period. The Company amortized $30 in 2002 and $90 in each of 2001 and 2000 to compensation expense relating to these options.

In December 2001, the Company granted to an employee an option to purchase 550 shares of Class A Common Stock at $2.91 per share (fair market value on the date of grant was $5.60 per share). In connection with the resignation of this employee in October 2002, this option was reduced to 100 shares, which were previously vested. The Company amortized $283 and ($14) for 2001 and 2002, respectively, to compensation expense relating to these options.

In December 2002 the Company announced a voluntary stock option exchange offer for the holders of stock options with an exercise price of $4.00 or more. Approximately 3,231 options were eligible for exchange in the offer. Immediately following the expiration of the offer on January 29, 2003, the Company accepted for exchange eligible options tendered to it for 2,857 shares of US LEC common stock and canceled all of these eligible options. The Company expects to grant the new options in early August 2003. The exercise price of the new options received in the exchange will be fair value on the date the new options are granted.

A summary of the option and warrant activity is as follows:

	Options			Warrants	
	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Fair Value at Date of Grant	Number of Warrants	Weighted Average Exercise Price Per Warrant
Balance at December 31, 1999	1,795	$14.30		299	$ 3.46
Granted at fair market value	1,226	$12.58	$8.51	—	—
Exercised	(29)	10.84		(131)	2.86
Forfeited or cancelled	(344)	19.12		—	—
Balance at December 31, 2000	2,648	$12.92		168	$ 3.92
Granted at fair market value	1,651	$ 4.41	$2.96	—	—
Granted at less than fair market value	550	2.91	4.41	—	—
Exercised	(2)	3.50		—	—
Forfeited or cancelled	(346)	12.12		(25)	10.00
Balance at December 31, 2001	4,501	$ 8.64		143	$ 2.86
Granted at fair market value	214	$ 4.30	$2.80	2,632	1.95
Exercised	(1)	3.50		—	—
Forfeited or cancelled	(693)	4.87		—	—
Balance at December 31, 2002	4,021	$ 9.06		2,775	$ 2.00

US LEC CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A summary of the range of exercise prices and weighted average remaining lives for options and warrants outstanding and exercisable at December 31, 2002 is as follows:

	Options Outstanding					
	Range of Exercise Price	Number of Options Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
Options granted at fair market value	$ 1.74 – $3.30	145	0.9 years	$ 2.91	26	$ 3.13
	— – 3.41	416	8.4 years	3.41	104	3.41
	3.50 – 4.11	419	0.2 years	3.96	132	3.89
	4.41 – 5.03	460	9.0 years	4.92	72	5.01
	5.81 – 6.88	593	7.9 years	6.00	230	6.02
	7.31 – 9.00	820	5.8 years	7.34	806	7.33
	— – 11.44	208	7.6 years	11.44	104	11.44
	12.30 – 26.13	784	6.0 years	20.60	555	20.50
	27.69 – 37.13	72	7.0 years	30.60	39	30.46
	1.74 – 37.13	3,917	7.5 years	9.22	2,067	10.81
Options granted at less than fair market value	2.91 – 10.00	104	1.4 years	3.26	104	3.16
Total options outstanding at December 31, 2002	$ 1.74 – $37.13	4,021	7.3 years	$ 9.06	2,171	$10.44

	Warrants Outstanding			
	Range of Exercise Price	Number of Warrants Outstanding and Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
Warrants granted at fair market value	$ 2.86	143	3 years	$2.86
	2.06	895	10 years	2.06
	$2.06 – 2.86	1,068	9 years	2.17
Warrants granted at less then fair market value	$ 1.90	1,737	10 years	1.90
Total warrants at December 31, 2002	$ 1.90 – 2.86	2,775	9.6 years	$2.00

The Company estimated the fair value of the Employee Stock Purchase Plan shares based upon the stock price at December 31, 2001 (the "issue date"). Compensation cost was estimated based upon the intrinsic value of the award at the issue date.

In 2000, additional paid-in-capital was reduced by approximately $36,000 representing amounts due from Metacomm, which is indirectly controlled by Richard T. Aab, the Company's Chairman and largest stockholder. Due to Mr. Aab's controlling position in both Metacomm and the Company, this amount was treated for financial reporting purposes as a deemed distribution to the stockholder.

On March 31, 2001, the Company, Richard T. Aab, the Company's Chairman, controlling shareholder at that time and the indirect controlling owner of Metacomm, and Tansukh V. Ganatra, the Company's former Vice Chairman and Chief Executive Officer, reached an agreement in principle to effect a recapitalization of the

Company and to resolve Mr. Aab's commitment that Metacomm would fully satisfy its obligations to the Company for facilities, advances and interest. This transaction was closed on August 6, 2001. Under the agreement, the following events occurred: (1) Mr. Aab made a contribution to the capital of the Company by delivering to the Company for cancellation 2,000 shares of Class B Common Stock, (2) Mr. Aab and Mr. Ganatra converted all of the then remaining and outstanding shares of Class B Common Stock—a total of approximately 14,000 such shares were outstanding after the 2,000 shares were cancelled—into the same number of shares of Class A Common Stock. As set out in the articles of incorporation, Class B Shares that have been converted to Class A can not be reissued (3) the Company agreed to indemnify Mr. Aab for certain adverse tax effects, if any, relating to the Company's treatment in its balance sheet of the amount of the Metacomm obligation as a distribution to shareholder and (4) the Company agreed to indemnify Mr. Ganatra for certain adverse tax effects, if any, from the conversion of his Class B shares to Class A shares. The Company has not recorded a liability associated with these indemnifications as management has concluded that as of December 31, 2002, it is not probable that any amounts would be payable. Based on a three-year statute of limitations, these indemnifications would expire in 2005. The Company is unable to estimate the maximum potential amount of future payments that may be due under these indemnifications due to a number of factors including the lack of information available regarding the individual tax affairs of Mr. Aab and Mr. Ganatra.

As required by the agreement, the Company obtained a valuation by a qualified valuation firm approved by the Company's audit committee that the delivery of the 2,000 shares of Class B Common Stock and the conversion of the approximately 14,000 shares of Class B Common Stock into the same number of shares of Class A Common Stock would result in the realization by the Company and its Class A shareholders of value approximately equal to the outstanding Metacomm obligation, received a favorable tax opinion, and received certain consents.

As a result of this transaction, the number of issued and outstanding shares of Common Stock (Class A and Class B together) decreased by 2,000 and, as a result of the elimination of the 10-vote-per-share Class B Common Stock, Mr. Aab no longer holds shares representing a majority of the voting power of the Company's outstanding Common Stock, although he remains its largest single shareholder.

In December 2002, additional paid-in-capital was increased by $2,320 representing the allocated portion of the $5,000 in gross proceeds received on December 31, 2002 which was allocated based on the approximate fair values of the Subordinated Notes and the 2002 Warrants. The Subordinated Notes are included in long-term debt and the 2002 Warrants are included in additional paid-in-capital in the accompanying consolidated balance sheet as of December 31, 2002 (see note 4).

11. LOSS PER SHARE

Loss per common and common equivalent share are based on net loss, after consideration of preferred stock dividends, and accretion divided by the weighted average number of common shares outstanding during the period. For all periods presented all common stock equivalents comprised of options and warrants disclosed in Note 10 above, are considered anti-dilutive and are therefore excluded from the calculation of the diluted loss per share.

12. QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table summarizes the Company's results of operations as presented in the consolidated statements of operations by quarter for 2002 and 2001.

	Quarter Ended			
	March 31, 2002	June 30, 2002	September 30, 2002	December 31, 2002
Revenue, Net	$ 53,938	$ 58,801	$ 63,892	$73,732*
Network Expenses	27,283	28,851	30,404	34,589
Selling, General and Administrative	25,928	27,896	29,538	29,516
Provision for Doubtful Accounts related to WorldCom	—	9,500	—	—
Depreciation and Amortization	10,553	11,068	11,291	12,150
Loss from Operations	(9,826)	(18,514)	(7,341)	(2,523)
Interest Income (Expense), Net	(1,901)	(1,946)	(1,943)	(1,898)
Net Loss	(11,727)	(20,460)	(9,284)	(4,421)
Preferred Stock Dividends	3,324	3,373	3,424	3,475
Accretion of Preferred Stock Issuance Cost	127	129	131	134
Net Loss Attributable to Common Stockholders	$(15,178)	$(23,962)	$(12,839)	$ (8,030)
Net Loss Attributable to Common Stockholders per Share:				
Basic and Diluted	$ (0.58)	$ (0.91)	$ (0.48)	$ (0.30)
Weighted Average Share Outstanding:				
Basic and Diluted	26,388	26,392	26,698	26,700

* Includes the impact of $3,582 increase in revenue as described in Note 13.

	Quarter Ended			
	March 31, 2001	June 30, 2001	September 30, 2001	December 31, 2001
Revenue, Net	$ 38,055	$ 43,051	$ 45,982	$ 51,514
Network Expenses	19,171	21,911	23,276	25,940
Selling, General and Administrative	24,228	26,017	38,087	26,566
Recovery for Disputed Receivables	—	—	(7,042)	—
Depreciation and Amortization	7,775	7,992	8,752	10,584
Loss from Operations	(13,119)	(12,869)	(17,091)	(11,576)
Interest Income (Expense), Net	(1,980)	(2,189)	(2,331)	(2,199)
Net Loss	(15,099)	(15,058)	(19,422)	(13,775)
Preferred Stock Dividends	3,131	3,178	3,226	3,275
Accretion of Preferred Stock Issuance Cost	120	122	124	125
Net Loss Attributable to Common Stockholders	$(18,350)	$(18,358)	$(22,772)	$(17,175)
Net Loss Attributable to Common Stockholders per Share:				
Basic and Diluted	$ (0.66)	$ (0.66)	$ (0.85)	$ (0.66)
Weighted Average Share Outstanding:				
Basic and Diluted	27,768	27,771	26,846	26,067

13. SUBSEQUENT EVENT

On January 15, 2003, the Company acquired certain assets including the Internet Service Provider ("ISP") customers of Eagle Communications, Inc. ("Eagle") in North Carolina, Georgia, Florida and Tennessee, and assumed certain operating liabilities in a transaction that will be accounted for as a purchase. The purchase price of this acquisition was $3.0 million consisting of $1.25 million paid in cash, and $1.75 million of subordinated notes with warrants to purchase 921 shares of the Company's common stock at an exercise price of $1.90 per share.

On March 12, 2003, the Company finalized the terms of a contract with an inter-exchange carrier ("IXC") for switched access services that had expired on March 13, 2002. The new contract covers switched access retroactive to March 14, 2002 through March 11, 2006. The Company had originally recorded an estimate of revenue earned for these services through December 31, 2002. The accompanying consolidated financial statements for fiscal 2002 reflect the increase in this estimate of $3,582 based on the retroactive terms of the new contract.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required in response to Item 10 related to directors is incorporated by reference from the sections of the Proxy Statement that appear under the heading "Election of Directors". The information required in response to Item 10 related to Executive Officers is provided in Part I of this report under the heading "Executive Officers of the Registrant".

ITEM 11. EXECUTIVE COMPENSATION

The information required to be furnished in response to Item 11 is incorporated by reference from the sections of the Proxy Statement that appear under the headings "Compensation of Directors" and "Compensation of Executive Officers".

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required to be furnished in response to Item 12 is incorporated by reference from the section of the Proxy Statement that appear under the heading "Security Ownership of Certain Beneficial Owners and Management".

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required to be furnished in response to Item 13 is incorporated by reference from the section of the Proxy Statement that appear under the heading "Certain Relationships and Related Transactions".

ITEM 14. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures within 90 days of the filing date of the annual report on Form 10-K. Based on this evaluation, our principal executive officer and principal financial officer have concluded that the design and operation of our disclosure controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date the evaluation was completed.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULE AND REPORTS ON FORM 8-K

(a) Financial Statements, Financial Statement Schedule and Exhibits—The following documents are filed as part of this Form 10-K.

(1) Financial statements:

A. Consolidated Balance Sheets as of December 31, 2002 and 2001

B. Consolidated Statements of Operations for the years ended December 31, 2002, 2001, and 2000

C. Consolidated Statements of Stockholders' Equity (Deficiency) for the years ended December 31, 2002, 2001 and 2000

D. Consolidated Statements of Cash Flows for the years ended December 31, 2002, 2001, and 2000

E. Notes to Consolidated Financial Statements for the years ended December 31, 2002, 2001, and 2000

F. Independent Auditors' Report

(2) Schedule II Valuation and Qualifying Accounts

(3) List of Exhibits:

No.	Exhibit
3.1	Restated Certificate of Incorporation of the Company (1)
3.2	Second Restated Bylaws of the Company
3.3	Certificate of Designation Related to Series A Convertible Preferred Stock (2)
3.4	Amendment to Certificate of Designation Related to Series A Convertible Preferred Stock (3)
4.1	Form of Class A Common Stock Certificate (1)
4.2	Preferred Stock Purchase Agreement, dated April 11, 2000 (2)
4.4	Corporate Governance Agreement, dated April 11, 2000 (2)
4.5	Registration Rights Agreement, dated April 11, 2000 (2)
4.6	Voting and Tag Along Agreement dated as of April 11, 2000 by and among certain Investors, Richard T. Aab, Melrich Associates, L.P., Tansukh V. Ganatra and Super STAR Associates Limited Partnership (3)
4.7	Amendment to Voting and Tag Along Agreement dated as of August 6, 2001 by and among Richard T. Aab, Melrich Associates, L.P., Super STAR Associates Limited Partnership, Bain Capital CLEC Investors, L.L.C., Thomas H. Lee Equity Fund IV, L.P., Thomas H. Lee Foreign Fund IV-B, L.P. and Thomas H. Lee Foreign Fund IV, L.P. (3)
4.8	Note Purchase Agreement, dated December 31, 2002 (4)
4.9	Form of Subordinated Note (4)
4.10	Form of Common Stock Purchase Warrant (4)
4.11	Registration Rights Agreement, dated December 31, 2002 (4)
4.12	Intercreditor and Subordination Agreement, dated December 31, 2002 (4)
10.1	Plan of Recapitalization dated August 6, 2001 by among the Company, Metacomm, LLC, Richard T. Aab, Melrich Associates, L.P., Tansukh V. Ganatra and Super STAR Associates Limited Partnership (3)
10.2	Indemnity Agreement dated as of August 6, 2001 by and among the Company, Metacomm, LLC, RTA Associates, LLC, Richard T. Aab and Joyce M. Aab (3)

No.	Exhibit
10.3	Indemnity Agreement dated as of August 6, 2001 by and among the Company, Tansukh V. Ganatra, Sarlaben T. Ganatra, Rajesh T. Ganatra and Super STAR Associates Limited Partnership (3)
10.4	Consulting Agreement dated as of February 7, 2002 by and between the Company and Tansukh V. Ganatra (3) (5)
10.5	Separation Agreement and Release, dated October 17, 2002, by and between the Company and Francis J. Jules (5)
10.6	Third Amended Loan and Security Agreement, dated as of December 31, 2002 (4)
10.7	First Amendment to the Third Amended Loan and Security Agreement, dated as of January 6, 2003
21	Subsidiaries of the Registrant
23	Consent of Deloitte & Touche LLP

(1) Incorporated by reference to Registration Statement from Form S-1 (File No. 333-46341) filed February 13, 1998.
(2) Incorporated by reference to the Company's Current Report on Form 8-K filed May 12, 2000.
(3) Incorporated by reference to the Company's Annual Report on Form 10-K for its year ended December 31, 2001.
(4) Incorporated by reference to the Company's Current Report on Form 8-K filed January 17, 2003.
(5) Management or compensatory plan or arrangement.

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

US LEC Corp. (IN THOUSANDS)

Description	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions	Balance at End of Period
Allowance against accounts receivable					
Year ended December 31, 2002	$12,263	$14,470*	$ —	$ 3,553	$23,180
Year ended December 31, 2001	$53,523	$ 6,586**	$3,318	$51,164	$12,263
Allowance against deferred tax assets					
Year ended December 31, 2002	$61,045	$18,644	$ —	$ —	$79,689
Year ended December 31, 2001	$35,669	$25,376	$ —	$ —	$61,045

* Includes $9,500 provision for doubtful accounts related to WorldCom.

** Represents the provision for doubtful reserves recorded during the year ended December 31, 2001 of $13,628 included in selling, general and administrative expenses in the accompanying consolidated statements of operations, net of the recovery of amounts previously reserved for disputed receivables of $7,042.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 31, 2003

By: /s/ RICHARD T. AAB
Richard T. Aab
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ RICHARD T. AAB **Richard T. Aab**	Chairman and Director	March 31, 2003
/s/ AARON D. COWELL, JR. **Aaron D. Cowell, Jr.**	Chief Executive Officer and Director (Principal Executive Officer)	March 31, 2003
/s/ MICHAEL K. ROBINSON **Michael K. Robinson**	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 31, 2003
/s/ TANSUKH V. GANATRA **Tansukh V. Ganatra**	Director	March 31, 2003
/s/ DAVID M. FLAUM **David M. Flaum**	Director	March 31, 2003
/s/ STEVEN L. SCHOONOVER **Steven L. Schoonover**	Director	March 31, 2003
/s/ ANTHONY J. DINOVI **Anthony J. DiNovi**	Director	March 31, 2003
/s/ MICHAEL A. KRUPKA **Michael A. Krupka**	Director	March 31, 2003

CERTIFICATION

I, Aaron D. Cowell, Jr., certify that:

1. I have reviewed this annual report on Form 10-K of US LEC Corp.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

   (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

   (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls, and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 31, 2003

By: /s/ AARON D. COWELL, JR.
Chief Executive Officer

CERTIFICATION

I, Michael K. Robinson, certify that:

1. I have reviewed this annual report on Form 10-K of US LEC Corp.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
   (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
   (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
   (a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls, and
   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 31, 2003

By: /s/ MICHAEL K. ROBINSON
Executive Vice President and Chief Financial Officer